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The President

EXECUTIVE ORDER 9393

POSSESSION AND OPERATION OF COAL MINES

WHEREAS widespread stoppages have occurred in the coal industry and strikes are threatened which will obstruct the effective prosecution of the war by curtailing vitally needed production in the coal mines directly affecting the countless war industries and transportation systems dependent upon such mines; and

WHEREAS it has become necessary for the effective prosecution of the war that the coal mines in which stoppages or strikes have occurred, or are threatened, be taken over by the Government of the United States in order to protect the interests of the nation at war and the rights of workers to continue at work:

NOW, THEREFORE, by virtue of the authority vested in me by the Constitution and laws of the United States particularly the War Labor Disputes Act, (Public Law 89, 78th Congress), as President of the United States and Commander-in-Chief of the Army and Navy, it is hereby ordered as follows:

The Secretary of the Interior is authorized and directed to take immediate possession, so far as may be necessary or desirable, of any and all mines producing coal in which a strike or stoppage has occurred or is threatened, together with any and all real and personal property, franchises, rights, facilities, funds, and other assets used in connection with the operation of such mines, and to operate or arrange for the operation of such mines in such manner as he deems necessary for the successful prosecution of the war, and to do all things necessary for or incidental to the production, sale and distribution of coal.

In carrying out this order, the Secretary of the Interior shall act through or with the aid of such public or private instrumentalities or persons as he may designate. He shall permit the management to continue its managerial functions to the maximum degree possible consistent with the aims of this order.

The Secretary of the Interior shall make employment available and provide protection to all employees resuming work at such mines and to all persons seeking employment so far as they may be needed; and upon the request of the Secretary of the Interior, the Secretary of War shall take such action, if any, as he may deem necessary or desirable to provide protection to all such persons and mines.

The Secretary of the Interior is authorized and directed to maintain customary working conditions in the mines and customary procedure for the adjustment of workers' grievances. He shall recognize the right of the workers to continue their membership in any labor organization, to bargain collectively through representatives of their own choosing, and to engage in concerted activities for the purpose of collective bargaining or other mutual aid or protection, provided that such concerted activities do not interfere with the operations of the mines.

The Secretary of the Interior is further authorized and directed to offer to the duly constituted representatives of the workers' own choosing a contract or contracts governing the terms and conditions of employment for the period of the operation of the mines by the Government, in accordance with the opinion of the National War Labor Board in the matter of Illinois Coal Operators Association and United Mine Workers of America of October 26, 1943, and with such further directives as may be given by the War Labor Board. When any such contract has been agreed upon, the Secretary of the Interior shall apply under section 5 of the War Labor Disputes Act to the National War Labor Board for the approval of such contract and such changes in the terms and conditions of employment as may be authorized therein.

Possession and operation of any mine or mines hereunder shall be terminated by the Secretary of the Interior as soon as he determines that possession and operation hereunder are no longer required for the furtherance of the war program, but in no event more than sixty

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TITLE 26—INTERNAL REVENUE

Chapter I—Bureau of Internal Revenue

Subchapter A—Income and Excess-Profits Taxes

[Regulations 111]

PART 29—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1941

Explanation of Regulations—Scope. The main body of these regulations deals with the income taxes imposed by chapter 1 (sections 1 to 476, inclusive) and subchapter A of chapter 2 (sections 500 to 511, inclusive) of the Internal Revenue Code, and with sections 3797 (definitions) and 3801 (mitigation of effect of limitation and other provisions) thereof. The regulations are applicable only with respect to taxable years beginning after December 31, 1941.

Arrangement and numbering. Each section, subsection, or paragraph of the Internal Revenue Code set forth in the regulations is followed by the section or sections (if any) of the regulations interpreting it. Sections of the Code may readily be distinguished from sections of the regulations, since each of the latter appears in larger type and bears a number commencing with 29 and a decimal point.

Each section of the regulations has been given a key number corresponding to the number of the section, subsection, or paragraph of the Internal Revenue Code which the regulations section interprets. Inasmuch as the regulations constitute Part 29 of Title 26 of the Code of Federal Regulations, each key number is preceded by the number 29 and a decimal point. The key number is followed by a dash (–) and the identifying number of the regulations section. By use of these key numbers one can readily ascertain how a given section, subsection, or paragraph of the Internal Revenue Code has been interpreted by the Bureau. Thus, one desiring to learn what interpretation has been placed on section 23 (d) of the Code should turn to § 29.23 (d)–1 of the regulations. In some cases several regulations sections are necessary in the interpretation of different phases of one section, subsection, or paragraph of the Code. For example, section 23 (m) of the Code, dealing with "Depletion," requires many regulations sections. Each of them, however, is designated by the key § 29.23 (m), for example, § 29.23 (m)–1, § 29.23 (m)–2, etc.

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AUTHORITY: §§ 29.1-1 to 29.3801 (e)-1 issued under sections 62 and 3791 of the Internal Revenue Code (53 Stat. 32, 467; 26 U.S.C., 62, 3791).

SUBPART A—INTRODUCTORY PROVISIONS

Pertinent Enacting Provisions of the Internal Revenue Code

AN ACT

To consolidate and codify the internal revenue laws of the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the laws of the United States hereinafter codified and set forth as a part of this act under the heading "Internal Revenue Title" are hereby enacted into law.

SEC. 2. CITATION. This act and the internal revenue title incorporated herein shall be known as the Internal Revenue Code and may be cited as "I. R. C.".

* * * * *

SEC. 6. ARRANGEMENT, CLASSIFICATION, AND CROSS REFERENCES. The arrangement and classification of the several provisions of the Internal Revenue Title have been made for the purpose of a more convenient and orderly arrangement of the same, and, therefore, no inference, implication or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion thereof, nor shall any outline, analysis, cross reference, or descriptive matter relating to the contents of said Title be given any legal effect.

* * * * *

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.

§ 29.1-1 *Scope and applicability of regulations.* These regulations deal with the taxes upon net income imposed by Chapter 1 of the Internal Revenue Code, including the tax imposed by section 102 upon the net income of certain corpora-

tions, and with 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.

These regulations are applicable only with respect to taxable years beginning after December 31, 1941.

Each section, subsection, or paragraph of the Internal Revenue Code set forth in these regulations shall be considered as a part of the respective regulations section to which it corresponds.

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. [as amended by sec. 172 (b), Rev. Act 1942.]

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 D—Victory tax on individuals, divided into parts and sections.

§ 29.3-1 *Division of regulations.* These regulations, which constitute Part 29 of Title 26 of the 1943 Supplement to the Code of Federal Regulations, are divided into six subparts. Subpart A relates to introductory provisions. Subpart B relates to general provisions. Subpart C relates to supplemental provisions. Subpart D relates to victory tax on individuals. Subpart E relates to surtax on personal holding companies. Subpart F relates to definitions. Subpart G relates to mitigation of effect of limitation and other provisions in income tax cases.

SEC. 4. SPECIAL CLASSES OF TAXPAYERS [as amended by sec. 102 (c), Rev. Act 1941; sec. 170 (b), Rev. Act 1942].

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 gross income from certain sources of $3,000 or less—Supplement T.

§ 29.4-1. *Application of regulations to special classes of taxpayers.* With respect to certain classes of taxpayers, the application of the provisions of Subpart B of these regulations is subject to certain exceptions and additional provisions, which appear in Subpart C, as follows:

Estates and trusts—sections 161 to 172, inclusive.

Partnerships—sections 181 to 190, inclusive.

Insurance companies—sections 201 to 207, inclusive.

Nonresident alien individuals—sections 211 to 219, inclusive.

Foreign corporations—sections 231 to 237, 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 with gross income from certain sources of $3,000 or less—sections 400 to 404, inclusive.

SUBPART B—GENERAL PROVISIONS

RATES OF TAX

SEC. 11. NORMAL TAX ON INDIVIDUALS [as amended by sec. 102 (b) (1), Rev. Act 1941; sec. 102, Rev. Act 1942].

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 6 per centum of the amount of the net income in excess of the credits against net income provided in section 25. (For alternative tax, if gross income from certain sources is $3,000 or less, see section 400).

§ 29.11-1 *Income tax on individuals.* Chapter 1 of the Internal Revenue Code imposes an income tax on individuals, including a normal tax (section 11), a surtax (section 12), and a victory tax (section 450). For optional tax in the case of taxpayers with gross income from certain sources of $3,000 or less, see section 400. The normal tax on individuals is at the rate of 6 percent and is upon net income, which is determined by subtracting the allowable deductions from the gross income. (See generally sections 21 to 24, inclusive.) In certain cases credits are allowed against the net income before computing the tax (section 25) and in other cases against the amount of the tax (sections 31, 32, and 131). In general, the tax is payable upon the basis of returns rendered by persons liable thereto (sections 51, 53 142, and 217), except that in some instances it is to be paid at the source of the income. Exceptions and additional provisions applicable to certain special classes of taxpayer are listed in section 4.

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.

§ 29.11-2 *Citizens or residents of the United States liable to tax.* In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax even though his income is wholly from sources outside the United States. As to nonresident alien individuals, see sections 211 to 219, inclusive.

§ 29.11-3 *Who is a citizen.* Every person born or naturalized in the United States, and subject to its jurisdiction, is a citizen. When any naturalized citizen has left the United States and resided for two years in the foreign country from which he came, or for five years in any other foreign country, it is presumed that he has ceased to be an American citizen. This presumption does not apply, however, to residence abroad while the United States is at war, nor does it apply in the case of individuals born in the United States subject to its jurisdiction. However, even though an individual born in the United States, subject to its jurisdiction, of either citizen or alien parents, resided in a foreign country for a number of years, he would still be a citizen of the United States, unless he had become naturalized in, or taken an oath of allegiance to, the foreign country of residence or some other foreign state. A foreigner who has filed his declaration of intention of becoming a citizen of the United States but who has not yet received his final citizenship papers is an alien. See §§ 29.211-2 to 29.211-5, inclusive, for distinction between a resident alien individual and a nonresident alien individual.

SEC. 12. SURTAX ON INDIVIDUALS [as amended by sec. 2, Rev. Act 1940; secs. 101, 102 (b) (2), Rev. Act 1941; secs. 103, 150 (j), Rev. Act 1942].

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

(b) *Rates of surtax.* There shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual the surtax shown in the following table:

If the surtax net income is:	*The surtax shall be:*
Not over $2,000	13% of the surtax net income.
Over $2,000 but not over $4,000	$260, plus 16% of excess over $2,000.
Over $4,000 but not over $6,000	$580, plus 20% of excess over $4,000.
Over $6,000 but not over $8,000	$980, plus 24% of excess over $6,000.
Over $8,000 but not over $10,000	$1,460, plus 28% of excess over $8,000.
Over $10,000 but not over $12,000	$2,020, plus 32% of excess over $10,000.
Over $12,000 but not over $14,000	$2,660, plus 36% of excess over $12,000.
Over $14,000 but not over $16,000	$3,380, plus 40% of excess over $14,000.
Over $16,000 but not over $18,000	$4,180, plus 43% of excess over $16,000.
Over $18,000 but not over $20,000	$5,040, plus 46% of excess over $18,000.
Over $20,000 but not over $22,000	$5,960, plus 49% of excess over $20,000.
Over $22,000 but not over $26,000	$6,840, plus 52% of excess over $22,000.
Over $26,000 but not over $32,000	$9,020, plus 55% of excess over $26,000.
Over $32,000 but not over $38,000	$12,320, plus 58% of excess over $32,000.
Over $38,000 but not over $44,000	$15,800, plus 61% of excess over $38,000.
Over $44,000 but not over $50,000	$19,460, plus 63% of excess over $44,000.

If the surtax net income is:	*The surtax shall be:*
Over $50,000 but not over $60,000	$23,240, plus 66% of excess over $50,000.
Over $60,000 but not over $70,000	$29,840, plus 69% of excess over $60,000.
Over $70,000 but not over $80,000	$36,740, plus 72% of excess over $70,000.
Over $80,000 but not over $90,000	$43,940, plus 75% of excess over $80,000.
Over $90,000 but not over $100,000	$51,440, plus 77% of excess over $90,000.
Over $100,000 but not over $150,000	$59,140, plus 79% of excess over $100,000.
Over $150,000 but not over $200,000	$98,640, plus 81% of excess over $150,000.
Over $200,000	$139,140, plus 82% of excess over $200,000.

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

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

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

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

(g) For alternative tax if gross income from certain sources is $3,000 or less, see section 400.

§ 29.12–1 *Surtax.* In addition to the normal tax imposed by section 11 a surtax is imposed at the rates specified in section 12 upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income is the amount of the net income in excess of the personal exemption and credit for dependents. (See generally §§ 29.25–1 to 29.25–7, inclusive.) For surtax on corporations improperly accumulating surplus, see section 102. As to surtax on personal holding companies, see sections 500 to 511, inclusive.

§ 29.12–2 *Computation of surtax.* The following table shows the surtax due for taxable years beginning after December 31, 1941, upon certain specified amounts of surtax net income. In each instance the first figure of the surtax net income in the surtax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the surtax net-income column. The last column gives the total surtax on a surtax net income equal to the second figure in the surtax net-income column.

SURTAX TABLE

Surtax net income	Percent	Total surtax
$0 to $2,000	13	$260
$2,000 to $4,000	16	580
$4,000 to $6,000	20	980
$6,000 to $8,000	24	1,460
$8,000 to $10,000	28	2,020
$10,000 to $12,000	32	2,660
$12,000 to $14,000	36	3,380
$14,000 to $16,000	40	4,180
$16,000 to $18,000	43	5,040
$18,000 to $20,000	46	5,960
$20,000 to $22,000	49	6,940
$22,000 to $26,000	52	9,020
$26,000 to $32,000	55	12,320
$32,000 to $38,000	58	15,800
$38,000 to $44,000	61	19,460
$44,000 to $50,000	63	23,240
$50,000 to $60,000	66	29,840
$60,000 to $70,000	69	36,740
$70,000 to $80,000	72	43,940
$80,000 to $90,000	75	51,440
$90,000 to $100,000	77	59,140
$100,00 to $150,000	79	98,640
$150,000 to $200,000	81	139,140
$200,000 up	82	

The surtax for any amount of surtax net income not stated in round figures in the table is computed by adding to the surtax for the largest amount stated which is less than the surtax net income, the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax upon a surtax net income of $63,128 would be $31,998.32, computed as follows:

Surtax on $60,000 from table	$29,840.00
Surtax on $3,128 at 69 percent	2,158.32
Total	31,998.32

SEC. 13. TAX ON CORPORATIONS IN GENERAL [as amended by sec. 201, Rev. Act 1939; sec. 3 (a), Rev. Act 1940; sec. 101 (a), 2d Rev. Act 1940; sec. 103 (a), Rev. Act 1941; sec. 105 (a), Rev. Act 1942].

(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 credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b).

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

(1) *General rule.* A tax of 24 per centum of the normal-tax net income; or

(2) *Alternative tax (corporations with normal-tax net income over $25,000 but not over $50,000).* A tax of $4.250, plus 31 per centum of the amount of the normal-tax net income in excess of $25,000.

(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.

§ 29.13–1 *Tax on corporations in general.* Section 13 imposes an income tax on corporations in general the normal-tax net income of which is more than $25,000. Every such corporation is liable to the tax imposed by such section, except (a) corporations expressly exempt from taxation under chapter 1 (see section 101); (b) corporations subject to tax under section 14, being (1) corporations having normal-tax net incomes of not more than $25,000 and not coming within the provisions of subsection (c), (d), or (e) of such section 14, and (2) foreign corporations engaged in trade or business within the United States; (c) foreign corporations not engaged in trade or business within the United States (see section 231 (a)); (d) insurance companies (see Supplement G (sections 201 to 207, inclusive)); and (e) regulated investment companies (see Supplement Q (sections 361 and 362)).

It makes no difference that a domestic corporation subject to any tax imposed by section 13 may derive no income from sources within the United States. The tax imposed by section 13 is computed upon the "normal-tax net income," that is, the adjusted net income minus the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2 and minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under chapter 1 (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 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.

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 surtax on corporations generally, see § 29.15–1. 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.

The manner of computing the tax imposed by section 13 depends upon the amount of the corporation's normal-tax net income. If the normal-tax net income is more than $50,000, the tax is 24 percent of the normal-tax net income. If the normal-tax net income is more than $25,000 and not more than $50,000, the tax is $4,250 plus 31 percent of the amount in excess of $25,000.

This section may be illustrated by the following examples:

Example (1). The A Corporation, a domestic corporation, which is not a bank affiliate referred to in section 26 (d), has for the calendar year 1942 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 dividends received (allowable as a credit under section 26 (b)) in the amount of $10,000. It also is entitled to a credit (allowable under section 26 (e)) for income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $20,000. The corporation's tax under section 13 for the calendar year 1942 is $21,960, 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
	111,500
Less credit for income subject to excess profits tax	20,000
Normal-tax net income	91,500
Tax under section 13 (b) (1) (24 percent of $91,500)	21,960

Example (2). Assuming that the A Corporation's normal-tax net income for 1942 is $41,500, instead of $91,500, its tax under section 13 for such year would be computed under section 13 (b) (2) and is $9,365, that is, $4,250 plus $5,115 (31 percent of $16,500, the excess of $41,500 over $25,000).

SEC. 14. TAX ON SPECIAL CLASSES OF CORPORATIONS [as amended by sec. 201, Rev. Act 1939; sec. 3 (b), Rev. Act 1940; sec. 101 (b), 2d Rev. Act 1940; sec. 103 (b) (c), Rev. Act 1941; secs. 160 (b), 170 (b), Rev. Act 1942].

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

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

Upon normal-tax net incomes not in excess of $5,000, 15 per centum.

$750 upon normal-tax net incomes of $5,000, and upon normal-tax net incomes in excess of $5,000 and not in excess of $20,000, 17 per centum in addition of such excess.

$3,300 upon normal-tax net incomes of $20,000, and upon normal-tax net incomes in excess of $20,000, 19 per centum in addition of such excess.

(c) *Foreign corporations.* (1) In the case of a foreign corporation engaged in trade or business within the United States, the tax shall be an amount equal to 24 per centum of the normal-tax net income, regardless of the amount thereof.

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

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

(e) *Regulated investment company.* In the case of a corporation subject to the tax imposed by Supplement Q (relating to regulated investment companies), the tax shall be as provided in such supplement.

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

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

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

§ 29.14-1 *Tax on special corporations.* Section 14 and this section are applicable with respect to taxable years beginning after December 31, 1941. See section 117 as to the treatment of capital gains and capital loses.

Section 14 imposes an income tax upon (1) corporations having normal-tax net incomes of not more than $25,000, and (2) foreign corporations engaged in trade or business within the United States. The tax imposed by section 14 is in lieu of the tax imposed by section 13. The tax is imposed upon the "normal-tax net income," for the definition of which see section 13 and § 29.13-1. Corporations expressly exempt from taxation under chapter 1 (see section 101) are not subject to the tax under section 14.

As in the case of corporations subject to the tax under section 13, it makes no difference that a domestic corporation subject to the tax imposed by section 14 may derive no income from sources within the United States. So, also, the tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 3797 (a). For surtax on corporations generally, see section 15 and § 29.15-1. For surtax on personal holding companies, see sections 500 to 511, inclusive. For surtax on corporations improperly accumulating surplus, see section 102.

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

The following table shows the income tax imposed by section 14 (b) upon certain specified amounts of normal-tax net income. In each instance the first figure of the normal-tax net income in the normal-tax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the normal-tax net-income column. The last column gives the total tax on a normal-tax net income equal to the second figure in the normal-tax net-income column.

TABLE OF CORPORATION INCOME TAX UNDER SECTION 14 (B)

Normal-tax net income	Percent	Total tax
$0 to $5,000	15	$750
$5,000 to $20,000	17	3,300
$20,000 to $25,000	19	4,250

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

The following example illustrates the computation of the tax imposed by section 14 (b):

Example. The A Corporation, a domestic corporation, has for the calendar year 1942 a net income of $28,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $9,000, and dividends received (allowable as a credit under section 26 (b)) in the amount of $5,000. It is also entitled to a credit (allowable under section 26 (e)) for income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $3,050. This tax upon the corporation under section 14 (b) is $1,883, computed as follows:

Net income	$28,000
Less credit for interest on United States obligations	9,000
Adjusted net income	19,000
Less credit for dividends received (85 percent of $5,000)	4,250
	14,750
Less credit for income subject to excess-profits tax	3,050
Normal-tax net income	11,700
Tax on $5,000 at 15 percent	750
Tax on $6,700 at 17 percent	1,139
Total tax	1,883

Section 14 (c) provides for a tax on foreign corporations engaged in trade or business within the United States equal to 24 percent of the normal-tax net income, regardless of the amount thereof. 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).

SEC. 15. SURTAX ON CORPORATIONS [as added by sec. 201, Rev. Act 1940, and amended by sec. 101 (d), 2d Rev. Act 1940; sec. 104 (a), Rev. Act 1941; sec. 105 (b), Rev. Act 1942].[1]

(a) *Corporation surtax net income.* For the purposes of this chapter, the term "corporation surtax net income" means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b).

(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 Western Hemisphere Trade Corporation as defined in section 109, and except a corporation subject to the tax imposed by section 231 (a), Supplement G, or Supplement Q), a surtax as follows:

(1) *Surtax net incomes not over $25,000.* Upon corporation surtax net incomes not over $25,000, 10 per centum of the amount thereof.

(2) *Surtax net incomes over $25,000 but not over $50,000.* Upon corporation surtax net incomes over $25,000, but not over $50,000, $2,500, plus 22 per centum of the amount of the corporation surtax net income over $25,000.

[1] The original section 15 of the Internal Revenue Code was eliminated by section 201 of the Revenue Act of 1939, which amended sections 13, 14, and 15 by enacting new sections 13 and 14 imposing taxes on the income of corporations for taxable years beginning after December 31, 1939.

(3) *Surtax net incomes over $50,000.* Upon corporation surtax net incomes over $50,000, 16 per centum of the corporation surtax net income.

§ 29.15-1 *Surtax on corporations.* Section 15 imposes a surtax upon the corporation surtax net income of every corporation, except (1) Western Hemisphere trade corporations (see section 109), (2) foreign corporations taxable under section 231 (a), (3) insurance companies (see Supplement G (sections 201 to 207, inclusive)), or (4) regulated investment companies (see Supplement Q (sections 361 and 362)).

The "corporation surtax net income" of a corporation is its net income minus (1) the credit provided in section 26 (e) for income subject to the excess-profits tax imposed by subchapter E of chapter 2, (2) the credit provided in section 26 (b) for dividends received, and (3) in the case of a public utility, the credit provided in section 26 (h) for dividends paid on its preferred stock. For the purposes of determining the corporation surtax net income, dividends received on the preferred stock of a public utility must be disregarded in computing the credit provided in section 26 (b) for dividends received. Also, for such purposes, such credit is limited to 85 percent of the corporation's net income (reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2), rather than to 85 percent of the adjusted net income so reduced. 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.

The rates of corporation surtax are as follows:

(1) Upon corporation surtax net incomes of $25,000 or less, 10 percent of the amount thereof.

(2) Upon corporation surtax net incomes over $25,000 but not over $50,000, $2,500, plus 22 percent of the amount of such income in excess of $25,000.

(3) Upon corporation surtax net incomes of more than $50,000, 16 percent of the entire amount thereof.

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

Example. The A Corporation, a domestic corporation which is not a public utility, has for the calendar year 1942 a net income of $86,000. The net income includes dividends received from a corporation which is not a public utility, in the amount of $9,000, and dividends received from the preferred stock of a public utility, in the amount of $3,000. It also includes income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $37,000. The A Corporation's surtax for the calendar year 1942 is $6,097, computed as follows:

Net income	$86,000
Less credit for income subject to excess profits tax	37,000
	49,000
Less credit for dividends received (85 percent of $9,000)	7,650
Corporation surtax net income	41,350
Tax ($2,500 plus 22 percent of $16,350, the excess of $41,350 over $25,000)	6,097

COMPUTATION OF NET INCOME

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

(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.

§ 29.21-1 *Meaning of net income.* 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:

(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the 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.)

(b) 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.)

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

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

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

The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. (See sections 23, 24, 102, 118, 121, 122, 203, 204, 207, 208, 232, 336, and sections 500 to 511, inclusive.)

SEC. 22. GROSS INCOME [as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943].

(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.

§ 29.22 (a)-1 *What included in gross income.* Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237, 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.

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see § 29.22 (a)-8.

The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to

the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. As to the amount of income tax paid for a bondholder by the obligor pursuant to a so-called tax-free covenant, see section 143 (a) (3). As to the determination of gain or loss from the sale or other disposition of property, see sections 111 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 202, 204, 206, 207, and 231.

§ 29.22 (a)-2 *Compensation for personal services.* Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, retired pay of Federal and other officers, and pensions or retiring allowances paid by 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. 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, 46 Stat. 468, 475, as amended (5 U.S.C., ch. 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.

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. The second sentence of this paragraph shall not apply where such an agreement or understanding has been entered into prior to May 14, 1942 (the date of the approval of Treasury Decision 5151).

§ 29.22 (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, 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 § 29.24-3.)

§ 29.22 (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.

§ 29.22 (a)-5 *Gross income from business.* In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see § 29.23 (m)-1 (f).

§ 29.22 (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.

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

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

taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See § 29.22 (c)-6.)

In every case of the sale of machinery, farm equipment, or other capital assets purchased after February 28, 1913 (which are not to be included in an inventory if one is used to determine profits) any excess over the cost thereof less the amount of depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income, shall be included as gross income. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or the equivalent of money. Proceeds of insurance, such as hail and fire insurance on growing crops, should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see § 29.-41-2), be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized.

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

Form 1040F should be filled in and attached to his income tax return by every farmer who either keeps no records or only records of cash receipts and disbursements; its use is optional with other farmers. (See further §§ 29.23 (a)-11, 29.23 (e)-5, and 29.23 (l)-10.)

§ 29.22 (a)-8 *Sale of stock and rights.* If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots 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 paragraphs (1), (2), (3), (4), and (5) of section 117 (h) (relating to the period for which property has been held) shall be applied. The excess of the amount realized on the sale over the cost or other basis of the stock will constitute gain. 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 §§ 29.113 (a) (19)-1 and 29.113 (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.

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 taxible 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:

(a) 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 1937 purchased 500 shares of common stock at $125 a share, and in 1942, 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 as 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.

(b) 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 paragraph (a). 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 1939 purchased 500 shares of common stock at $125 a share, and in 1942, 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 paragraph (a)) +$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.

(c) 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 § 29.113 (a) (12)-1.

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 § 29.23 (e)-1.

§ 29.22 (a)-9 *Sale of patents and copyrights.* A taxpayer disposing of patents or copyrights by sale should determine the gain or loss arising therefrom by computing the difference between the selling price and the cost or other basis, with proper adjustment for depreciation, as provided in §§ 29.111-1, 29.113 (a) (14)-1, and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive.

§ 29.22 (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 §§ 29.111-1, 29.113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, 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.

§ 29.22 (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.

§ 29.22 (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 § 29.22 (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 § 29.22 (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.

§ 29.22 (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 § 29.22 (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 § 29.22 (b) (9)-1. For exclusion from gross income attributable to discharge of indebtedness of railroad corporations in certain judicial proceedings, see § 29.22 (b) (10)-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, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under:

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

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

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

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

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

For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness required by the Bankruptcy Act, as amended, see §§ 29.113 (b) (1)-2 and 29.113 (b) (1)-3.

§ 29.22 (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.

§ 29.22 (a)-15 *Acquisition or disposition by a corporation of its own capital stock.* 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.

But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stocks 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.

§ 29.22 (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 §§ 29.22 (a)-13 and 29.24-2.)

§ 29.22 (a)-17 *Sale and purchase by corporation of its bonds.* (a) (1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (2) 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. (3) 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) (1) 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. (2) 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. (3) 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) (1) 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. (2) 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. (3) 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) (1) 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. (2) 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. (3) 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.

For exclusion from gross income of income attributable to discharge of indebtedness of certain corporations, see § 29.22 (b) (9)-1. For exclusion from gross income of income attributable to discharge of indebtedness of railroad corporations in certain judicial proceedings, see § 29.22 (b) (10)-1.

§ 29.22 (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.

§ 29.22 (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 let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or shareholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the shareholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns.

§ 29.22 (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 § 29.44-5. (See further § 29.52-2.)

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

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

§ 29.22 (b)-1 *Exemptions; exclusions from gross income.* Certain items of income specified in section 22 (b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government; (2) those items of income which are exempt from tax on income under the provisions of any Act of Congress still in effect; and (3) the income exempted under the provisions of section 116. Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the 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), and 171 and Supplements G, H, I, and J (sections 201 to 252, inclusive). Section 607 (f) of the Merchant Marine Act of 1936, as amended by section 28 of the Act of June 23, 1938 (52 Stat. 961), and changed to section 607 (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.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

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

§ 29.22 (b) (1)-1 *Life insurance; amounts paid by reason of the death of the insured.* The proceeds of life insurance policies, paid by reason of the death of an insured to his estate or to 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 § 29.22 (b) (2)-3 and in the case of a spouse to whom such payments are income under section 22 (k). 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. In the case of a beneficiary to whom payments are made in installments pursuant to an option exercised by such beneficiary, the amount exempted is the amount payable immediately after the death of the insured had such beneficiary not elected to exercise an option to receive the proceeds of the policy or any part thereof at a later date or dates. In any mode of settlement pursuant to an agreement of the insurer with a beneficiary the portion of each distribution which is to be included in gross income shall be determined as follows:

(a) *Proceeds held by the insurer.* If the proceeds are held by the insurer under an agreement with a beneficiary to distribute either the increment to such proceeds currently, or the proceeds and increment in equal installments until

both are exhausted, there shall be included in gross income, the increment so paid to the beneficiary, or so credited to the fund in each year by the insurer.

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

If the proceeds are payable in installments to a spouse who was divorced or legally separated from the insured under a court decree, such proceeds are to be excluded from the income of such spouse to the extent provided in the preceding paragraph only if not required to be included in her gross income under section 22 (k), relating to alimony income. Thus, if under the terms of a divorce decree, an insurance policy upon the life of the husband is to be purchased by him to provide a principal sum of $10,000 payable upon his death in 10 annual installments, with interest, to his divorced wife, the full amount of such installments received by the wife, including the interest, is to be included in her income. See further section 22 (b) (2), section 22 (k), § 29.22 (b) (2)-4, and § 29.22 (k)-1.

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

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

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

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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.

§ 29.22 (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.

§ 29.22 (b) (2)-2 *Annuities.* Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semiannually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. Such portion of each installment payment of an annuity (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, 46 Stat. 468, 475, as amended (5 U. S. C., 1940 ed., ch. 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.

The provisions of this section may be illustrated by the following examples:

Example (1). A bought in 1939, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1942 he would be required to include in gross income $1,500 of the $5,000 received during that year (3 percent of $50,000), $3,500 being exempt. If A should live long enough to receive as exempt $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

Example (2). A bought an annuity on October 1, 1942, 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, 1942, 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 1942 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, 1942, 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, 1942, amounting to $250. A shall include in his gross income for the calendar year 1942 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).

§ 29.22 (b) (2)-3 *Transfers of life insurance, endowment, or annuity contracts.* 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 § 29.22 (b) (1)-1, 29.22 (b) (2)-1, or 29.22 (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.

The following examples illustrate the application of the provisions of this section:

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 1922, 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 (1942), 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.

§ 29.22 (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 § 29.22 (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 § 29.22 (b) (2)-2 on the basis of the consideration paid by her to the company.

§ 29.22 (b) (2)-5 *Employees' annuities.* 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 § 29.23 (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 § 29.22 (b) (2)-2, the consideration for the annuity being considered the amount contributed by the employee. 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 contracts 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 § 29.22 (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.

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 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 § 29.165-6.

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 employees' rights are nonforfeitable.

As to taxation of annuities purchased by a trustee under a pension or profit-sharing trust, see §§ 29.165-6 and 29.165-7.

As to the effective date of the amendments made by section 162 (c) of the Revenue Act of 1942, relating to employees' annuities and the effect of such amendments on both old and new annuity plans, see section 162 (d) of the Revenue Act of 1942 (set forth immediately preceding §§ 29.23 (p)-1) and 29.165-5.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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. 111. INCOME RECEIVED FROM ESTATES, ETC., UNDER GIFTS, BEQUESTS, ETC. (Revenue Act of 1942.)

* * * * *

(e) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1941; except that in the case of income paid, credited or to be distributed or amounts paid, credited or to be distributed by an estate or trust the amendments made by this section shall be applicable only with respect to such income and such amounts paid, credited or to be distributed on or after the beginning of the first taxable year of the estate or trust, as the case may be, beginning after December 31, 1941.

§ 29.22 (b) (3)-1 *Gifts and bequests.* Property received as a gift, or received under a will or under statutes of descent and distribution, is 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 § 29.22 (k)-1.

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.

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.

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.

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.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939, secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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 corporation organized under Act of Congress, if such corporation is an instrumentality of the United States; or (C) the obligations of the United States or its possessions. Every person owning any of the obligations enumerated in clause (A), (B), or (C) shall, in the return required by this chapter, submit a statement showing the number and amount of such obligations owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit 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;

PUBLIC DEBT ACT OF 1941 (APPROVED FEBRUARY 19, 1941)

* * * * *

SEC. 4. (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.

PUBLIC DEBT ACT OF 1942 (APPROVED MARCH 28, 1942)

* * * * *

SEC. 6. Section 4 of the Public Debt Act of 1941 (Public Numbered 7, Seventy-seventh Congress, first session), 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.

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

(c) Nothing contained herein shall be construed to amend or repeal sections 114 and 115 of the Revenue Act of 1941.

§ 29.22 (b) (4)-1 *Interest upon State obligations.* Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exception, 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.

§ 29.22 (b) (4)-2 *Dividends from shares and stock of Federal agencies or instrumentalities*—(a) *Issued prior to March 28, 1942.* Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 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 (38 Stat. 258, 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 5 (h) of the Home Owners' Loan Act of 1933 (48 Stat. 133, 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, and Federal reserve banks is not, in the case of stock issued prior to 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 prior to 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 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.

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.

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 (48 Stat. 267, 12 U.S.C., 1138c)).

(b) *Issued on or after March 28, 1942.* 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.

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. This paragraph 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 prior to 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 prior to March 28, 1942, the shares having been paid for prior to 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 prior to 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 prior to 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.

§ 29.22 (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 (39 Stat. 380, 12 U. S. C., 931), and section 210 of such Act, as added by section 2 of the Act of March 4, 1923 (42 Stat. 1450, 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.

§ 29.22 (b) (4)-4 *Interest upon United States obligations*—(a) *Issued prior to March 1, 1941.* 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 instrumenality of the United States, is generally exempt from tax, in the case of obligations issued by the United States after September 1, 1917, which include Treasury certificates of indebtedness, Treasury bonds, and Treasury notes, and in the case of obligations of a corporation organized under Act of Congress, the interest is exempt from tax only if and to the extent provided in the Acts authorizing the issue thereof, as amended and supplemented.

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

The interest on Treasury certificates of indebtedness is entirely exempt from Federal income taxes. Interest upon Treasury notes is exempt only to the extent provided in the terms of the issue. Interest (discount at which issued) on Treasury bills and any gain from the sale or other disposition of such bills are also entirely exempt from Federal income taxes. With respect to the nondeductibility of losses from the sale or other disposition of such bills, see § 29.23 (e)-1.

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

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

Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U. S. C., 931), and section 210 of such Act, as added by section 2 of the Act of March 4, 1923 (42 Stat. 1459, 12 U. S. C., 1111), provided 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.

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

(b) *Issued on or after March 1, 1941.* By virtue of the provisions of sections 4 and 5 of the Public Debt Act of 1941 (55 Stat. 9), the exemption prescribed in paragraph (a) of this section is limited to such bonds, debentures, notes, or certificates of indebtedness as have been issued prior to March 1, 1941. Under such provisions of the Public Debt Act of 1941, 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 now or hereafter imposed except in respect of any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to 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.

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.

§ 29.22 (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.

§ 29.22 (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 (40 Stat. 1311), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (40 Stat. 845), 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 prior to 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 § 29.22 (b) (4)-4 (b).

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a), (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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;

(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 makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, 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. This paragraph shall not apply to any discharge occurring before the date of enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1945.

§ 29.22 (b) (9)-1 *Income from discharge of indebtedness.* Section 22 (b) (9) provides, with respect to taxable years beginning after December 31, 1941, and before January 1, 1946, a method whereby a corporation may elect to have excluded from its gross income the amount of 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 the provisions of section 22 (b) (9) for such years 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 §§ 29.113 (b) (3)-1 and 29.113 (b) (3)-2, relating to adjustment of basis).

As used in this section "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.

Discharges of indebtedness (including discharges occurring in a proceeding under Chapter XV of the Bankruptcy Act of 1898, as amended, if such proceeding was initiated by petition filed on or after October 16, 1942, and on or before November 1, 1945) occurring in a taxable year beginning after December 31, 1941, and prior to January 1, 1946, are governed by the provisions of section 22 (b) (9).

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.

Section 22 (b) (9) and this section are inapplicable in the case of any discharge occurring in any proceeding under section 77B of the Bankruptcy Act of 1898, as amended, under Chapter X or XI of such Act, or under Chapter XV of such Act if the proceeding under such chapter was initiated by a petition filed on or before July 31, 1940 (see paragraphs 3 to 16, inclusive, of the Appendix to these regulations), and with respect to any discharge of indebtedness to which section 22 (b) (10) applies.

§ 29.22 (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 §§ 29.113 (b) (3)-1 and 29.113 (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.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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, 1945.

§ 29.22 (b) (10)-1 *Income from discharge of indebtedness of railroad corporations.* 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 of 1898, as amended, is, for taxable years beginning before January 1, 1946, 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.

The railroad corporations to which this section and section 22 (b) (10) apply are those defined in section 77m of the Bankruptcy Act of 1898, as amended, 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.

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.

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.

The provisions of section 22 (b) (10) and this section are applicable to taxable years beginning before January 1, 1946.

[SEC. 22. GROSS INCOME—as amended by sec. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; Sec. 7 (a), Current Tax Payment Act 1943.]

[(b) *Exclusion 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.

§ 29.22 (b) (11)-1 *Exclusion from gross income of lessor of real property of value of improvements erected by lessee.* 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.

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

Example. The A Corporation leased in 1935 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, 1937. 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, 1942, 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. If, in this example, the lease covered a period of only 25 years and the building upon completion had an estimated value of $75,000 as of the end of the lease term and in accordance with an option granted by the regulations the A Corporation included in gross income the sum of $3,000 for each taxable year from 1937 to 1941, both years inclusive, then there shall be excluded from gross income for the taxable year 1942 and subsequent taxable years any such amounts otherwise includible in gross income for such years and attributable to the building erected by the B Corporation, notwithstanding the exercise of such option. As to the basis of the property in the hands of the A Corporation, see § 29.113 (c)-1.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

[(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.

§ 29.22 (b) (12)-1 *Recovery of bad debts, prior taxes and delinquency amounts*—(a) *In general*. Section 22 (b) (12) provides that incomes 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. In substance, the recovery exclusion is an amount equal to the portion of such items 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*. 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. The bad debts, prior taxes, and delinquency amounts referred to in that section, called "section 22 (b) (12) items" in this section, are only those for which a deduction or credit was allowed for a prior taxable year. Thus, 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.

(2) *Definition of "recovery."* Recoveries result from the receipt of amounts in respect of the previously deducted or credited items described in section 22 (b) (12), 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), resulting 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*. For taxable years beginning after December 31, 1937, bad debts on account of certain worthless securities and, for taxable years beginning after December 31, 1942, certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See section 23 (k) of the Internal Revenue Code, and section 23 (k) of the Revenue Act of 1938. The amount of the deductions allowed for any year under section 117 (d) on account of such losses for such year is 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. Bad debts are considered the last capital losses deducted under section 117 (d) or carried over under section 117 (e).

(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 (2), below, of this paragraph) and (ii) reduced by the 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.* The recovery exclusion for the taxable year for which section (b) (12) items were deducted or section 22 (b) (12) items were deducted or credited (that is, the "original taxable 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, surtax, and victory tax), 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 this purpose, consideration must be given to the effect of net operating loss carry-overs and carry-backs or capital loss carry-overs.

The preceding paragraph 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:

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

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

(iii) For taxable years beginning on or after January 1, 1943, in the case of taxpayers other than corporations, the difference between (*a*) the income subject to victory tax (the victory tax net income reduced by the specific exemption) for such original year and (*b*) the income subject to victory tax computed without regard to the section 22 (b) (12) items for such original year.

(iv) 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 (*a*) the income subject to such tax for such original year and (*b*) 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 (*a*) nor the amount under (*b*) of (i), (ii), (iii), or (iv) above 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 (i), (ii), (iii), and (iv) above, the computation of each carry-over or carry-back to the preceding or succeeding year being made under subdivision (*a*) of (i), (ii), (iii), and (iv) with regard to the section 22 (b) (12) items for the original year, and such computation being made under subdivision (*b*) without regard to such items. For the purposes of the preceding sentence, the computations under both subdivisions (*a*) and (*b*) 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.

Example. A single individual, who has no dependents, has for 1942 $2,800 gross income, $2,000 business expenses, and a deduction of $900 for bad debts and of $700 for property taxes. His income and deductions for 1941 are set out below. His recovery exclusion on account of the section 22 (b) (12) items for 1942 (the debts and taxes) is $500, determined as follows:

The $1,600 aggregate of the section 22 (b) (12) items is reduced by the $300 difference between the surtax net income for 1942 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 section 22 (b) (12) items	Without deduction of section 22 (b) (12) items
Gross income	$2,800	$2,800
Less: Business expenses	2,000	2,000
Remainder	800	800
Less: Bad debts and taxes	1,600	----------
Net income or (loss)	(800)	800
Personal exemption	500	500
Surtax net income	0	300
Earned income credit	0	80
Net income subject to normal tax	0	220
Difference between surtax net incomes ($300-$0)	----------	300
Difference between incomes subject to normal tax ($220-$0)	----------	220

The taxpayer had no items which would cause section 122 (d) adjustments for 1942 or 1941. For 1941 he had $6,000 gross income, and his only deduction was a net operating loss deduction of $800 based on his loss for 1942. There would be no net operating loss deduction for 1941 if the carry-back to 1941 was computed without regard to the section 22 (b) (12) items for 1942. Accordingly, $800 of such items for 1942 resulted, by way of carry-back to 1941, in a reduction of tax for 1941, since net income subject to normal tax and surtax net income for 1941 were reduced to the extent of the carry-back (computed in the manner set forth in the preceding paragraph). The $1,600 aggregate of the section 22 (b) (12) items for 1942 is further reduced by the $800 which caused a reduction in tax through the carry-back. Therefore, the recovery exclusion for the items for 1942 is $500, that is, the $1,600 aggregate of such items reduced by the $300 and by the $800.

In 1946 the taxpayer recovers $400 of the property taxes. All of this recovery is excluded from income by reason of the recovery exclusion of $500 determined for the original year 1942. In 1947 he recovers all of the bad debt of $900, of which $100 is excluded from gross income. That is, the recovery exclusion of $500 determined for the original year 1942 is reduced by the $400 recovery in 1946 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.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942, sec. 7 (a), Current Tax Payment Act 1943]

[(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 military and naval personnel.* In the case of compensation received during any taxable year and before the termination of the present war as proclaimed by the President, by a member of the military or naval forces of the United States for active service in such forces during such war, or by a citizen or resident of the United States who is a member of the military or naval forces of any of the other United Nations for active service in such forces during such war, so much of such compensation as does not exceed $1,500. [NOTE: Under sec. 7 (b), Current Tax Payment Act 1943, this provision is applicable with respect to taxable years beginning after December 31, 1942. The corresponding provision applicable with respect to taxable years beginning after December 31, 1941, and before January 1, 1943, is as follows: "(13) *Additional allowance*

for military and naval personnel. So much of the amount received before the termination of the present war as proclaimed by the President, by personnel below the grade of commissioned officer in the military or naval forces of the United States as salary or compensation in any form from the United States for active service in such forces during such war, as does not exceed $250 in the case of a single person and $300 in the case of a married person or head of a family. The determination, for the purposes of this paragraph, of the taxpayer's status in the armed forces and his family status shall be made as of the end of the taxable year."]

§ 29.22 (b) (13)-1 *Compensation of military and naval forces*—(a) *Taxable years beginning after December 31, 1942.* For any taxable year beginning after December 31, 1942, in addition to other exemptions and credits otherwise applicable, there may be excluded from gross income in the case of:

(1) A member of the military or naval forces of the United States or

(2) A citizen or a resident of the United States who is a member of the military or naval forces of any of the other United Nations

so much of the compensation for active service in such forces during the present war as does not exceed the sum of $1,500. Such exclusion is applicable without distinction as to the rank or as to the marital status of the recipient of such compensation but is applicable only to such compensation received prior to the termination of the present war to be fixed by proclamation of the President. If the husband and wife both meet such requirements, then each is entitled to exclude such amount from gross income. For the purposes of this section the military and naval forces of the United States include (but are not necessarily limited to) the Army, the Navy, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Navy Nurse Corps, Female, the Women's Army Auxiliary Corps or the Women's Army Corps, the Women's Reserve branch of the Naval Reserve, the Marine Corps Women's Reserve, and the Coast Guard Reserve, including the Coast Guard Women's Reserve. For the purposes of this subsection the term "member of the military or naval forces of any of the other United Nations" shall mean any individual whose duties in the service of any of the United Nations other than the United States correspond to those of any member of the military or naval forces of the United States as defined in this section.

A person is in active service if he is actually serving in such forces, not necessarily in the field or in the theater of war. Personnel in the inactive reserve or on retirement are not in active service. Periods during which a person is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service.

This exemption does not apply to salary or compensation received by such person subsequent to discharge or release from active service even though payment may have been made as compensation for services rendered while in active service.

(b) *Taxable years beginning in 1942.* For any taxable year beginning after December 31, 1941, and prior to January 1, 1943, a person below the grade of commissioned officer in active service in the military or naval forces of the United States during the present war may exclude from gross income salary or compensation received in any form from the United States for such service, in an amount not in excess of $250 if single or $300 if married or the head of a family. If the husband and wife both meet such requirements, then each is entitled to the $300 exclusion. The exemption under this paragraph does not apply to compensation received before January 1, 1942, or after the close of the taxable year of the taxpayer beginning before January 1, 1943.

As to what constitutes the military and naval forces of the United States for the purposes of this paragraph, see paragraph (a) of this section. For the purposes of this paragraph, personnel serving with the Army Specialist Corps are not within the scope of the exemption. As to what constitutes active service for the purposes of this paragraph, see paragraph (a) of this section.

This exemption does not apply to salary or compensation received by such person subsequent to discharge or release from active service even though payment may have been made as compensation for services rendered while in active service.

For the purposes of this paragraph, whether a person is in active service in the military or naval forces of the United States and whether such person is single, married, or the head of a family is determined by such person's status on the last day of the taxable year.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

(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.

§ 29.22 (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 seggregated 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 § 29.22 (d)-1.)

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

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

(b) It must clearly reflect the income.

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

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (a) cost and (b) cost or market, whichever is lower. (For inventories by dealers in securities, see § 29.22 (c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22 (d). Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in § 29.41-2. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22 (d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

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

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

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

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

(3) Omitting portions of the stock on hand.

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

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

§ 29.22 (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 live stock (see § 29.22 (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 § 29.22 (c)-7), and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 29.22 (c)-8).

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

(a) Of goods purchased and on hand, and

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

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

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

§ 29.22 (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 § 29.41-2. 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.

§ 29.22 (c)-6 *Inventories of livestock raisers and other farmers.* Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (a) and (b) below. It is optional with the taxpayer which method is used, but, having elected one method, the option so ex-

ercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method be authorized by the Commissioner.

(a) 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.

(b) 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:*

(1) 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;

(2) 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.

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," which provides for the valuation of inventories at market price less direct cost of disposition. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in § 29.41-2. In such case the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year. If such valuation of the opening inventory for the taxable year in which the change is made results in an abnormally large income for that year, there may be submitted with the return for such taxable year an adjustment statement for the preceding year. This statement shall be based on the "farm-price method" of valuing inventories, upon the amount of which adjustments the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such preceding year. If an adjustment for the preceding year is not, in the opinion of the Commissioner, sufficient clearly to reflect income, adjustment sheets for prior years may be accepted or required.

If returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into 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.

§ 29.22 (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 inventories under elective method.

§ 29.22 (c)-8 *Inventories of retail merchants.* Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided (1) that the use of such method is designated upon the return, (2) that accurate accounts are kept, and (3) that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in § 29.41-2. Under this method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as:

(a) The total of the retail selling prices of 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

(b) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year,

bears to (a).

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

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

A taxpayer 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 herein prescribed. 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.

In no event shall mark-downs not based on actual reduction of retail sales 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.

A taxpayer 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, § 29.41-2. A taxpayer filing a first return of income may adopt such practice subject to approval by the Commissioner upon examination of the return.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

(d) (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.* If, for any taxable year beginning after December 31, 1941, and prior to the termination of the present war as proclaimed by the President, 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, at the time of the filing of the taxpayer's income tax return for such year, the taxpayer elects to have the provisions of this paragraph apply and so notifies the Commissioner, and if, at the time of such election, it is established to the satisfaction of the Commissioner, in accordance with such regulations as the Commissioner may prescribe with the approval of the Secretary, 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 not more than three years after the termination of the present war as proclaimed by the President, 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 Subchapter E of Chapter 2 for the year of such liquidation and for all taxable years intervening between such year 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 included in the 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 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 Subchapter E of 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).

§ 29.22 (d)-1 *Inventories under elective method.* Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22 (c), and pursuant to the provisions of §§ 29.22 (c)-1 to 29.22 (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 elective inventory method, the taxpayer is permitted to treat those goods 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 and to the extent thereof, and

Second, those acquired during the taxable year.

This elective 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.

If the elective 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 tax-

payer and that, in the opinion of the Commissioner, income is clearly reflected thereby.

§ 29.22 (d)-2 *Requirements incident to adoption and use of elective method.* The adoption and use of the elective inventory method is, by section 22 (d) and 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, at costs determined as follows:

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

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

(3) 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

(4) 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 elective inventory method is used by the taxpayer;

Example (1). Suppose that the taxpayer adopts the elective inventory method for the taxable year 1942 with an opening inventory of 10 units at 10 cents per unit, that it makes 1942 purchases of 10 units as follows:

January	1	@	11=11
April	2	@	12=24
July	3	@	13=39
October	4	@	14=56
Totals:	10		130

and that it has a 1942 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—

10 @ 10	=100
4 @ 14 (October)	= 56
1 @ 13 (July)	= 13
Totals: 15	169

or

(b) In order of acquisition—

10 @ 10	=100
1 @ 11 (January)	= 11
2 @ 12 (April)	= 24
2 @ 13 (July)	= 26
Totals: 15	161

or

(c) At an annual average—

10 @ 10	=100
5 @ 13 (130/10)	= 65
Totals: 15	165

Example (2). Suppose, in addition to the facts stated in example (1), that there is a 1943 closing inventory of 13 units. This closing inventory, being determined wholly by reference to the opening inventory, and being taken in the order of acquisition, and depending upon the taxpayer's method of valuing its inventory increase for the preceding taxable year, will be computed as follows:

(a) In case the increase was taken as most recent purchases—

10 @ 10 (from 1941)	=100
1 @ 13 (July, 1942)	= 13
2 @ 14 (October, 1942)	= 28
Totals: 13	141

or

(b) In case the increase was taken in order of acquisition—

10 @ 10 (from 1941)	=100
1 @ 11 (January, 1942)	= 11
2 @ 12 (April, 1942)	= 24
Totals: 13	135

or

(c) In case increase was taken on basis of an average—

10 @ 10 (from 1941)	=100
3 @ 13 (from 1942)	= 39
Totals: 13	139

(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 elective 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 § 29.22 (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 elective 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 elective 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 § 29.22 (d)-1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter; and

(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 § 29.22 (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.

§ 29.22 (d)-3 *Time and manner of making election.* The elective 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 (or, if such return is filed prior to March 10, 1943, the ninetieth day after the approval of Treasury Decision 5199, then at any time prior to such date), 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 elective 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 of finished products. Each group of products shall be clearly described.

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

As a condition to the taxpayer's use of the elective inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the tax-

payer'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.

Whether or not the taxpayer's application for the adoption and use of the elective 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.

§ 29.22 (d)-4 *Adjustments to be made by taxpayer.* A taxpayer may not change to the elective 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.

§ 29.22 (d)-5 *Revocation of election.* An election made to adopt and use the elective 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 § 29.41-2.

§ 29.22 (d)-6 *Change from elective inventory method.* If the taxpayer is granted permission by the Commissioner to discontinue the use of the elective 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 elective method by reason of the taxpayer's failure to conform to the requirements detailed in § 29.22 (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 elective inventory computations; or

(b) If the elective 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 elective inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the elective inventory method and had no goods currently subject to inventory by a method other than the elective 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.

§ 19.22 (d)-7 *Involuntary liquidation and replacement.* If prevailing war conditions beyond the control of the taxpayer should render it impossible during the period of the war for a taxpayer using the elective 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 the time of filing his income tax return for the year of the liquidation 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. 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.

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 prior to the termination of the present war as proclaimed by the President, and to inventory replacements effected in taxable years ending not more than three years after the termination of the war so proclaimed.

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 (i) enemy capture or control of sources of limited foreign supply; (ii) shipping or other transportation shortages; (iii) material shortages resulting from priorities or allocations; (iv) labor shortages; and (v) 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.

If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decreases suffered during war years, he must so elect at the time of filing his income tax return for the year reflecting the decrease. In making such election, the taxpayer shall attach to his return and make a part thereof 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; (4) detailed proof of such circumstances to the extent that they may not be the subject matter of common knowledge; and (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.

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 prospective replacement, and shall be binding for the year of liquidation, the year of replacement, and all intervening and subsequent years to the extent that such 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. Adjustments are to be made for the intervening and subsequent years consistent with the adjustments made for the year of liquidation. De-

tailed 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.

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 included in the closing inventory for the year of replacement, and in that of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

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. 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.

In some cases it may appear at the time of the filing of the income tax return for the year of replacement, or at the time of the Commissioner's examination of such return, that an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some intervening taxable years, 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 3-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 subparagraph (E) of the liquidation and replacement enactment. The adjustment authorized by subparagraph (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 section 734 (d) and those sections of the regulations prescribed thereunder. 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.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act. 1942; sec. 7 (a), Current Tax Payment Act 1943.]

(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 3789.

(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).) [NOTE: Under section 120 (g) of the Revenue Act of 1942 this provision is applicable only with respect to taxable years beginning after December 31, 1941; except that if the first taxable year beginning after December 31, 1941, of the husband does not begin on the same day as the first taxable year beginning after December 31, 1941, of the wife, this provision shall first become applicable in the case of the husband on the first day of the wife's first taxable year beginning after December 31, 1941, regardless of the taxable year of the husband in which such day falls.]

§ 29.22 (k)-1 *Alimony and separate maintenance payments; income to former wife*—(a) *In general.* 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 of the regulations 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).

In general, 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:

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

(2) 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.

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

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

(2) 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 § 29.171-1 in cases where such periodic payments are attributable to property held in trust.

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 1942. The court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1942, 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 1942 by W is includible in her income for 1942. 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 entered prior to 1942. During 1942, 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 for taxable years beginning after December 31, 1941. (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 § 29.171-1.)

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.

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.* 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 § 29.22 (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.

The same rule applies to perodic 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. This rule applies even though under the law applicable to taxable years beginning before January 1, 1942, only the income of a trust for the benefit of the divorced wife was taxable to her. 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 these regulations. 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 § 29.171-1.

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 transfers 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 § 29.22 (b) (2)-4.

(c) *Alimony installment payments.* 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.

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 1940 provides that H is to pay W $20,000 each year for the next 5 years, beginning with the date of the decree and then $5,000 each year for the next 10 years. Assuming the wife makes her returns on the calendar year basis, each payment received in 1942, 1943, and 1944 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 1945-1954, 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 1941, H agrees to pay W $500 on the 1st 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 1942 and, in addition, on December 31, 1942, pays W $1,500 as an advance payment of installments for the next three months. In the calendar year 1943, H makes no payments at all because of financial straits. On January 1, 1944, H inherits $15,000, which he immediately pays to W in satisfaction of not only his back alimony installments for the last 9 months of 1943 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 1942, 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 1942. For 1943, nothing is includible in her income under section 22 (k). In 1944, 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 1944. Of the balance of $10,500, only $7,200 is includible in her income for 1944.

As to H: For the taxable year ended June 30, 1942, H paid $6,000, of which only $3,000 is deductible by H since only that much of the $6,000 was paid in the wife's first taxable year beginning after December 31, 1941. In the taxable year ended June 30, 1943, 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, 1944, 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. As to treatment of such amounts with respect to credit for dependents and head of family exemption, see sections 25 (b) (2) (A) and 401 (a) (2) and §§ 29.25-4 and 29.25-6.

[SEC. 22. GROSS INCOME—as amended by secs. 1, 3, Public Salary Tax Act 1939; secs. 215 (a), 219 (a), Rev. Act 1939; secs. 110 (a), 111 (a), 112 (a), 113, 114 (a) (b), 115 (a), 116 (a), 117, 118 (a) (b), 119, 120 (a) (d), 127 (d), 134 (c), 162 (c), Rev. Act 1942; sec. 7 (a), Current Tax Payment Act 1943.]

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

SEC. 23. DEDUCTIONS FROM GROSS INCOME [as amended by secs. 211 (a), 224, Rev. Act. 1939; secs. 301, 508 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942].

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.

(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, claimed the benefits of the election provided in section 733, 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 (a), 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.

§ 29.23 (a)-1 *Business expenses.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (z), inclusive, and the regulations thereunder. 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 § 29.23 (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 § 29.22 (a)-5.) Among the items included in business expenses are management expenses, commissions (but see § 29.24-2), 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 § 29.23 (a)-2.), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

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

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

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

(c) If an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, the amount of the allowance should be in-

cluded in gross income and the cost of such meals and lodging may be deducted therefrom.

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

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

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

§ 29.23 (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.

§ 29.23 (a)-4 *Repairs.* The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See §§ 29.23 (l)-1 to 29.23 (l)-10, inclusive.)

§ 29.23 (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.

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

(a) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (1) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (2) 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.

(b) 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.

(c) 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.

§ 29.23 (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.

§ 29.23 (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.

§ 29.23 (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).

§ 29.23 (a)-10 *Rentals.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduc-

tion 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. However, if the taxpayer for any taxable year ending prior to December 31, 1939, has been allowed such depreciation or amortization on the basis of spreading the cost or other basis of such lease or improvements over the number of years the lease has to run, including any exercised or unexercised renewal period or periods, and such taxable year has been closed on that basis and the tax for that year cannot be redetermined, then the taxpayer may for subsequent taxable years take deductions on such basis if within 90 days after the approval of Part 24 of this chapter (approved December 6, 1939) or within such later period as may be specified by the Commissioner, he files Form 969, in duplicate, with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, signifying his election to have deductions in respect of such items determined upon such basis, and expressly waives his right to claim or receive the benefits of any reduction in his tax liability which would result from the allowance of deductions for such items on the basis of only the number of years the lease has to run, without taking into account any right of renewal, or on any basis other than that set forth in his election. If, in any case, the life of the improvements is less than the number of years the lease has to run, including the renewal period if properly to be considered, the deduction for depreciation with respect to such improvements shall be spread only over such life.

§ 29.23 (a)-11 *Expenses of farmers.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see § 29.41-2), 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 § 29.22 (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 §§ 29.22 (a)-7, 29.23 (e)-5, and 29.23 (l)-10.)

§ 29.23 (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.

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

The limitations provided in 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.

§ 29.23 (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 733 to charge to capital account expenditures for advertising or the promotion of good will which may be regarded as capital investments and which were deducted for taxable years beginning after December 31, 1935, and prior to January 1, 1940, 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 733. 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 § 30.733-2 of this chapter.

§ 29.23 (a)-15 *Nontrade or nonbusiness expenses*—(a) *In general.* 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 (1) above.

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 actully 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.

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.

(b) 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 clases of tax-exempt income, other than interest, and has the effect in addition of disallowing 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.

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.

Among expenditures not allowable under section 23 (a) (2) are the following: Commuters' 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.

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.

Ordinary and necessary expenses in connection with the management, conservation, or maintenance of property used as a residence by the taxpayer or acquired by him for such use are not deductible, even though the taxpayer makes efforts to sell the property at a profit or to convert it to income-producing purposes, and even though the property is not occupied by the taxpayer as a residence, unless prior to the time that such expenses are incurred the property has been rented or otherwise appropriated to income-producing purposes by some affirmative act and has not been reconverted.

Expenditures incurred by an administrator or executor in securing the processes and orders of the court having jurisdiction over the probate of the estate, or in collecting the assets of the estate (other than income which, if and when realized, must be reported by the estate for income tax purposes), or in adjusting claims against the decedent, or in distributing the remaining assets to the beneficiaries, or in conserving the assets for ultimate distribution to the parties entitled thereto, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or executor for the production or collection of income which, if and when realized, must be reported by the estate for income tax purposes, such as fees for collecting rents on property in the estate of the decedent, or for collecting interest or dividends on securities in that estate, or which are paid or incurred during the taxable year for the management, conservation, or maintenance of property in the estate of the decedent held for the production of income, the income from which, if and when realized, must be reported by the estate for income tax purposes, such as expenditures for insurance or repairs, or expenditures of a similar nature, are deductible under this section at the option of the taxpayer notwithstanding that deductions therefor are allowable under section 812 (b) in computing the gross estate subject to the estate tax, provided the requisite statement and waiver are filed. (See section 162 (e).)

The ordinary expenditures of administration incurred in a receivership or bankruptcy proceeding are not deductible. Such expenditures include expenditures incurred in the performance of the ordinary duties of a receiver or trustee in bankruptcy, as, for example, fees paid to the attorney for the petitioning creditors, fees paid to the appraisers, and disbursements which are made in connection with the proceeding and which look toward the collection of the assets and their preservation pending ultimate distribution to the parties entitled thereto.

Reasonable amounts paid or incurred by a trustee on account of trustees' fees and other expenses which are ordinary and necessary in connection with the production or collection of trust income or with the management, conservation,

or maintenance of trust property held for the production of income are deductible, notwithstanding that the trust is not engaged in a trade or business.

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.

It is immaterial whether the expenses of fiduciaries are paid from the corpus of the estate or from income. Expenses derive their character not from the fund from which they are paid, but from the purposes for which they are incurred.

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 hei- or legatee, or as beneficiary under a testamentary trust, are not deductible expenses. Expenditures incurred for the purpose of preparing tax returns (except tc the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

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.

(c) 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.

§ 29.23 (a)-16 *Wage and salary payments in contravention of wage and salary limitations not deductible*—(a) *General.* In any case in which a wage or salary payment, for which a deduction would otherwise be allowable, is determined by the National War Labor Board, by the Secretary of Agriculture, or by the Commissioner to have been made in contravention of the Act of October 2, 1942 (Public Law 729, 77th Congress), entitled "An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes," as amended by the Public Debt Act of 1943 (Public Law 34, 78th Congress), or of the regulations, orders, or rulings promulgated thereunder, the entire amount of such payment shall be disallowed as a deduction. Such a payment will not be allowed for this purpose notwithstanding that the same payment is also disallowed (1) for the purpose of determining costs or expenses of an employer for the purpose of some other law or regulation, either heretofore or hereafter promulgated, including the Emergency Price Control Act of 1942, or any maximum price regulation thereof; or (2) for the purpose of determining costs or expenses under any contract made by or on behalf of the United States.

(b) *Amount of illegal wage or salary payment not deductible*—(1) *Unauthorized wage or salary increases.* In the case of a wage or salary increased in contravention of the Act, or of the regulations, rulings, or orders referred to under paragraph (a) of this section, the amount which is not to be allowed as a deduction under this section is the amount of the wage or salary actually paid or accrued by the employer at the increased rate and not merely an amount representing the increase in such wage or salary. Thus, if, for example, on November 1, 1942, a weekly salary rate of $100 or a wage rate of $2 an hour is unjustifiably increased for the remainder of 1942 to $150 or $3, respectively, then the amounts not deductible under this section are the total weekly amounts of $150 or the total hourly amounts of $3, as the case may be. Also, if, for example, on February 1, 1943, a weekly salary rate of $100 or a wage rate of $2 an hour is increased without prior required approval to $150 or $3, respectively, but is restored on June 1, 1943, after formal disapproval, to $100 or $2, respectively, then the amounts not deductible under this section are the total weekly amounts of $150 or the total hourly amounts of $3, as the case may be, paid from February 1, 1943, to June 1, 1943, inclusive.

(2) *Unauthorized wage or salary decreases.* In the case of a wage or salary decrease in contravention of the Act, or of the regulations, rulings, or orders referred to under paragraph (a) of this section, the amount which will not be allowed as a deduction under this section is the amount of the wage or salary actually paid or accrued by the employer at the reduced rate. Thus, if, for example, on November 1, 1942, a weekly salary rate of $100 or a wage rate of $2 an hour has been unjustifiably reduced for the remainder of the calendar year 1942 to $90 or $1.80, respectively, the amounts not deductible under this section are the total weekly amounts of $90 or the total hourly amounts of $1.80, as the case may be.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 153 (b), 162 (b), Rev. Act 1942.]

[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.

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

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments 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.

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 and § 29.22 (a)-17.) 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 in-

vestment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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, 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; and

(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.

(2) *Excess-profits tax under chapter 2E—Special rules.* [Paragraph (2) repealed by sec. 105 (c) (2), Rev. Act 1942.]

(3) *Retail sales tax.* 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, 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 purchaser (otherwise than in connection with the purchaser's trade or business) to such person such amount shall be allowed as a deduction in computing the net income of such purchaser as if such amount constituted a tax imposed upon and paid by such purchaser.

§ 29.23 (c)-1 *Taxes*—(a) *In general.* Subject to the exceptions stated in this section and §§ 29.23 (c)-2 and 29.23 (c)-3, taxes imposed by the United States, any State or Territory, or political subdivision of either, possessions of the United States, or foreign countries, are deductible from gross income for the year in which paid or accrued (see section 43). Estate, inheritance, legacy, succession, and gift taxes and Federal income taxes 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).) See generally §§ 29.131-1 to 29.131-8, inclusive, as to tax credits. Postage is not a tax. Amounts paid to States or Territories under secured debts laws in order to render securities tax exempt are deductible. Automobile license fees are ordinary 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 taxes.* Amounts representing sales taxes paid by a purchaser of services or tangible personal property are deductible by such purchaser 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 tax does not fall on the purchaser 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 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 purchaser be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. Where the law imposing the sales 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 tax was separately stated at the time paid by the purchaser.

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.

§ 29.23 (c)-2 *Federal duties and excise taxes.* Import or tariff duties paid to the proper customs officers, and business, license, privilege, excise, and stamp taxes paid to internal revenue collectors, are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they cannot be separately deducted. (See § 29.23 (a)-1.)

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

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs, 301, 506 (b), 2d Rev. Act. 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

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

§ 29.23 (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 reimbusement 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.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126

(a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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.

§ 29.23 (e)-1 *Losses by individuals.* Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the 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 section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113 (b). For special provisions with respect to war losses, see section 127.

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

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

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

Example (1). Residential property was purchased by a taxpayer in 1932 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, 1939. From that date to January 1, 1942, 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, 1939, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1939. The property was sold on January 1, 1942, 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 1932	$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, 1939	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 1932	$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $10,000, cost of building)	1,500
	18,500
Selling price of property	16,000
Loss computed as provided in section 111	2,500
Deductible loss, except as limited by section 117	2,500

Losses from the sale or other disposition of Treasury bills issued after June 17, 1930, and before March 1, 1941, are not deductible.

§ 29.23 (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.

§ 29.23 (e)-3 *Loss of useful value.* When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and §§ 29.113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, 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 or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

If the depreciable assets of a taxpayer consist of more than one item and depreciation, whether in respect of items or groups of items, is based upon the average lives of such assets, losses claimed on the normal retirement of such assets are not allowable, inasmuch as the use of an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in

the group have been retired. In order to account properly for such retirement the entire cost or other basis of assets retired, adjusted for salvage, will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered.

In cases in which depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113 (b) and §§ 29.113 (a) (14)-1, and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, 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.

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 §§ 29.113 (a) (14)-1, and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive) less its salvage value is allowable upon its retirement. (See §§ 29.23 (l)-1 to 29.23 (l)-10, inclusive.)

§ 29.23 (e)-(4) *Shrinkage in value of stocks.* A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and §§ 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive, 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 § 29.22 (c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally, including stocks and bonds, see section 117.

§ 29.23 (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 after February 28, 1913, for any purpose, and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such 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 § 29.23 (e)-1. See also §§ 29.22 (a)-7, 29.23 (a)-11, and 29.23 (l)-10.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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. * * *

§ 29.23 (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 §§ 29.23 (e)-1 to 29.23 (e)-5, inclusive, and § 29.23 (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.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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 subsection[1] 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, dividends, interest, annuities, or gains from sales or exchanges of stocks and securities; and

(C) the taxpayer is a domestic corporation.

§ 29.23 (g)-1 *Capital Losses.* Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. Losses sustained by virtue of securities becoming worthless during the taxable year are, under section 23 (g), made subject to the limitations provided in section 117 with respect to sales or exchanges, provided the securities are "capital assets" as that term is defined in § 29.117 (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

[1] So in original. "As used in paragraph (2) of this subsection" evidently intended.

are deemed destroyed or seized under section 127, relating to war losses.

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.

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

Example. A, an individual, who is not a dealer in corporate stocks or stock rights and whose taxable year is the calendar year, purchased 120 shares of stock in the X Corporation on February 1, 1941, for which he paid $3,000. In June 1942 the stock became worthless. A is entitled to a deduction of $1,500 in computing his net income for 1942. The deduction is computed as follows:

Purchase price	$3,000
Amount realized	None
Actual loss	$3,000
Period stock considered to have been held (February 1, 1941, to December 31, 1942)	23 months
Percentage of loss taken in account under section 117 (b)	50 percent
Long-term capital loss (50 percent of $3,000) (section 117 (a) (5))	$1,500

§ 29.23 (g)-2 *Loss on stock of affiliate.* 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 § 29.23 (g)-1. For the purposes of section 23 (g) (2), section 23 (g) (4), § 29.23 (g)-1, and this section a corporation shall be deemed to be affiliated with the taxpayer only if all the following factors are present:

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

(b) 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, dividends, interest, annuities, or gains from sales or exchanges of stocks and securities, and

(c) The taxpayer is a domestic corporation.

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 1936. 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 1934. 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 1942. 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 section 29.23 (g) 1. Consequently, in computing the net income of Corporation S for 1942, 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.

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 § 29.23 (k)-4.

[Sec. 23. Deductions from gross income—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 153 (b), 162 (b), Rev. Act 1942.]

[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.

§ 29.23 (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.

[Sec. 23. Deductions from gross income—as amended by secs. 211 (a), 224 Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940: sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a), (c), 128, 134 (d), 153 (b), 162 (b), Rev. Act 1942.]

[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.

§ 29.23(i)-1 *Basis for determining loss.* The basis for determining the amount of the deduction for losses allowed to individuals under section 23 (e) and to corporations under section 23 (f), or of the amount of the deduction for bad debts allowed to both individuals and corporations under section 23 (k), is the same as is provided in section 113 for determining the loss from the sale or other disposition of property. Proper adjustment must be made in each case for any expenditure, receipt, loss, or other item properly chargeable to capital account, and for depreciation, obsolescence, amortization, or depletion. (See section 113 (b) and §§ 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive.)

[Sec. 23. Deductions from gross income—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a), (c), 128, 134 (d), 153 (b), 162 (b), Rev. Act 1942.]

[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 which becomes worthless 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. [The last sentence of this paragraph is, under section 124 (d), Rev. Act, 1942, applicable only with respect to taxable years beginning after December 31, 1942.]

(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. [This paragraph is, under sec. 124 (d), Rev. Act 1942, applicable only with respect to taxable years beginning after December 31, 1942.]

(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 incomes for all taxable years has been from sources other than royalties, rents, dividends, interest or annuities or gains from sales or exchanges of stock and securities; and

(C) the taxpayer is a domestic corporation.

§ 29.23 (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.

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 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 § 29.23 (k)-5.)

(b) If, from all the surrounding and attending circumstances, the Commissioner is satisfied that a debt is partially worthless, the amount which has become worthless during the taxable year shall be allowed as a deduction in computing net income. 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 has become worthless during the taxable year. 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.

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.

(c) Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders of such supervisory officers charge off debts in whole or in part, such debts shall, 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 the taxable year in which the debt becomes worthless or partially worthless, as the case may be, then such charge-off will be deemed to have been involuntary and the deduction shall be allowed for the year in which the debt becomes worthless or partially worthless, as the case may be.

(d) The provisions of paragraphs (a) and (b) of this section apply to all taxpayers, except that (1) they do not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness debt as defined in paragraph (4) of section 23 (k) of the Code; (2) no deduction on account of worthlessness shall be allowed with respect to any debt of the type enumerated in section 23 (k) (5) of the Code which is recoverable only in part; and (3) in the case of taxpayers other than banks as defined in section 104, the term "debts" as used in such subdivisions means obligations to pay fixed or determinable sums of money which are not evidenced by securities as defined in § 29.23 (k)-4.

§ 29.23 (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.

§ 29.23 (k)-3 *Uncollectible deficiency upon sale of mortgaged or pledged property.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the 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 or 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.

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

§ 29.23 (k)-4 *Worthless bonds and similar obligations.* 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.

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.

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.

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, he may deduct in computing the 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.

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

Example (1). On February 1, 1941, A, an individual, who is not a dealer in corporate bonds, purchased bonds of the X Corporation bearing interest coupons payable semiannually, for which he paid $3,000. During the calendar year 1942 (his taxable year) the bonds became worthless. A is entitled to a deduction of $1,500 in computing his net income for 1942. The computation of the amount of the deduction is the same as the computation in the example under § 29.23 (g)-1.

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

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) and (b) of § 29.23 (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, dividends, interest, or annuities, or gains from the sales or exchanges of stocks and securities and if the taxpayer is a domestic corporation.

§ 29.23 (k)-5. *Reserve for bad debts*. Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with § 29.23 (k)-1, adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

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

§ 29.23 (k)-6 *Non-business bad debts*. In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, 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 non-business 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 non-business 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 paragraph (1) of that section.

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 non-business debt for the purposes of this amendment.

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 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. 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 1942 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 1943, 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 1942 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. 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 1942 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 1943, 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 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. 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 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

The provisions of this section with respect to non-business debts are applicable only to taxable years beginning after December 31, 1942.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

(l) *Depreciation.* A reasonable allowance for the exhauston, 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.

§ 29.23 (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 § 29.23 (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 124.

§ 29.23 (l)–2 *Depreciable property.* The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under § 29.23 (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 § 29.23 (a)–4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under § 29.23 (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.

§ 29.23 (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.

§ 29.23 (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.

§ 29.23 (l)–5 *Method of computing depreciation allowance.* The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduc-

tion for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

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

Example. An asset was purchased January 1, 1937, 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 1937 to 1941 as follows:

1937	$1,000.00
1938	---------
1939	2,000.00
1940	2,000.00
1941	---------
Total amount allowed	5,000.00

The correct amended reserve as of December 31, 1941, is computed as follows:

December 31—	
1937	$1,000.00
1938	1,000.00
1939	2,000.00
1940	2,000.00
1941	666.67
Reserve December 31, 1941	6,666.67

Depreciation for 1942 and subsequent taxable years is $666.67, computed as follows:

Cost	$10,000.00
Reserve as of December 31, 1941	6,666.67
Unrecovered cost	3,333.33
Depreciation allowable for 1942 and each subsequent taxable year (6⅔ percent of $10,000)	666.67

§ 29.23 (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 fuuture 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.

§ 29.23 (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.

§ 29.23 (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.

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

§ 29.23 (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 § 29.22 (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 §§ 29.23(a)-11 and 29.23(e)-5.)

[Sec. 23. Deductions from gross income—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; Secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

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

portioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

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

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

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. 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.

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. (But see § 29.115-6.) The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See § 29.23 (l)-1.)

When used in these sections (§§ 29.23 (m)-1 to 29.23 (m)-28, inclusive) covering depletion and depreciation:

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

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

(c) 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.

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

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

(f) "Gross income from the property," as used in section 114 (b) (3) and (4) and §§ 29.23 (m)-1 to 29.23 (m)-28, inclusive, means the amount for which the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine or well, but, if the product is transported or processed (other than by the processes excepted below) before sale, it means the representative market or field price (as of the date of sale) or crude mineral product of like kind and grade before such transportation or processing. 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 state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes not listed below. The processes excepted are as follows:

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

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

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

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

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

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments 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 § 29.23 (m)-10 (e).

(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 §§ 29.23 (m)-1 to 29.23 (m)-28, inclusive, means the "gross income from the property" as defined in paragraph (f) 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) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (f), 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) 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) 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) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) "Crude mineral product," as used in paragraph (f) of this section, 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 §§ 29.23 (m)-1 to 29.23 (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.

§ 29.23 (m)-2 *Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion.* The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in section 113 (a), adjusted as provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (See §§ 29.113 (a)-1 to 29.114-1, inclusive.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

As used in this 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.

"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.

In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (a) amounts representing the cost or value of the land for purposes other than mineral production, (b) the amount recoverable through depreciation and through deductions other than depletion, and (c) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in § 29.23 (m)-16, are recoverable through depletion.

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

§ 29.23 (m)-3 *Computation of depletion of mines (other than metal, coal, fluorspar, ball and sagger clay, rock asphalt, or sulphur mines) on basis of discovery value.* The basis upon which depletion is to be computed in the case of mines (other than metal, coal, fluorspar, ball and sagger clay, rock asphalt, or sulphur mines) discovered by the taxpayer after February 28, 1913, is the fair market value of the property at the date of discovery or within 30 days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to cost. The value must be equitably apportioned between the owners of the economic interests therein. For the method of determining whether a discovery has been made, see § 29.23 (m)-14. For the method of determining the fair market value, see § 29.23 (m)-7.

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

The depletion allowance based on discovery value under this 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 § 29.23 (m)-1 (g).

This section does not apply to metal mines, coal mines, fluorspar mines, ball and sagger clay mines, rock asphalt mines, or sulphur mines or deposits, or to oil or gas wells.

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.

"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.

§ 23.23 (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 § 29.23 (m)-1 (f) 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.

§ 29.23 (m)-5 *Computation of depletion based on percentage of income in case of coal mines, metal mines, fluorspar mines, ball and sagger clay mines, rock asphalt mines, and sulphur mines or deposits.* Under section 114 (b) (4) a taxpayer may deduct for depletion an amount equal to 5 percent of the gross income from the property during the taxable year in the case of coal mines, an amount equal to 15 percent of the gross income from the property during the taxable year in the case of metal, fluorspar, ball and sagger clay, or rock asphalt mines, and an amount equal to 23 percent of the gross income from the property during the taxable year in the case of sulphur mines or deposits, but such deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see § 29.23 (m)-1 (f) 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.

A taxpayer may compute the depletion allowance provided in this section, or in § 29.23 (m)-2, without regard to any election previously made in respect of computation of the allowances.

§ 29.23 (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.

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

(b) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors essential in the case of all mineral deposits are (1) the total 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 deposit. In case of oil and gas properties the additional factors are (i) the total quantity of oil and gas in terms of the principal or customary unit (or units) paid for in the product marketed, (ii) the quantity of oil and gas expected to be recovered during each operating period, (iii) the average quality or grade of the oil and gas reserves, (iv) the allocation of the total expected profit to the several processes or operations necessary for the preparation of the oil and gas for market, (v) the probable operating life of the deposit in years, (vi) the development cost, and (vii) 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 § 29.23 (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 §§ 29.23 (m)-15 and 29.23 (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 § 29.23 (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.

§ 29.23 (m)-8 *Revaluation of mineral deposits not allowed.* No revaluation of a property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of a subsequent discovery of nonmetallic minerals, other than fluorspar, ball and sagger clay, rock asphalt, coal, sulphur, oil, or gas, as defined in § 29.23 (m)-14, or of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The value should, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation. The value should be redistributed:

(a) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23 (m) and § 29.23 (m)-9, and

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

§ 29.23 (m)-9 *Determination of mineral contents of mines and of oil or gas wells.* If it is necessary to estimate or determine with respect to any property as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousand 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 detemination must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade:

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

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

If the number of recoverable units of mineral in the property 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.

§ 29.23 (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) above, the owner of an economic interest in oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the owner of an economic interest in sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 23 percent, 15 percent, and 5 percent, respectively, of the amount thereof; but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. The owner of an economic interest in fluorspar, ball and sagger clay, or rock asphalt mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 15 percent of the amount thereof, but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

(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 paragraph (e) (2) above. 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.

§ 29.23 (m)-11 *Depletion and depreciation accounts on books.* Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property shall keep accurate ac-

counts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the mineral deposit and of the plant and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments required by section 113 (b).

If the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with §§ 29.23 (m)-2, 29.23 (m)-3, 29.23 (m)-4, or 29.23 (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 §§ 29.23 (m)-3, 29.23 (m)-4, or 29.23 (m)-5.

Every taxpayer to whom section 114 (b) (2) and § 29.23 (m)-3 are applicable shall keep similar accounts with respect to discovery value.

§ 29.23 (m)-12 *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.* (a) Except as provided in § 29.23 (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 the 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 must be furnished under oath, should be summarized, and may be included in a single affidavit.

(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.

§ 29.23 (m)-13 *Statement to be attached to return when depletion is claimed on percentage basis.* (a) There shall be attached to the return of every taxpayer who claims depletion of oil and gas wells under section 114 (b) (3) and § 29.23 (m)-4, or depletion of coal mines, metal mines, fluorspar mines, ball and sagger clay mines, rock asphalt mines, or sulphur mines or deposits under section 114 (b) (4) and § 29.23 (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 § 29.23 (m)-1 (f), 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 § 29.23 (m)-1 (g); and

(3) The information required by paragraphs (a) (1), (a) (2), (a) (3), and (b) of § 29.23 (m)-12. The other information required by § 29.23 (m)-12 shall also be furnished if necessary in determining the gain or loss from the sale or other disposition of the property during the taxable year or if a valuation of the property is necessary for any purpose. The taxpayer may find it desirable to furnish such information in all cases.

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

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

(b) A mine or minerals of a kind not excepted by this 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 § 29.23 (m)-7, based on what is evident within 30 days after the commercially valuable character and extent of the discovered deposits of mineral have with reasonable certainty been established, determined, or proved.

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

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

§ 29.23 (m)-16 *Charges to capital and to expense in case of oil and gas wells*—(a) *Taxable years beginning prior to January 1, 1943* The provisions of this paragraph apply only to taxable years beginning prior to January 1, 1943.

(1) Items chargeable to capital or to expense at taxpayer's option:

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

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

(iii) 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.

(2) Recovery of optional items, if capitalized:

(i) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this 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.

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

casing and equipment and in the construction on the property of derricks and other physical structures.

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

(3) Nonoptional items distinguished:

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

(ii) Expense items: Expenditures which must be charged off as expense, regardless of the options provided by paragraph (a) of 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. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

(4) Paragraph (a) of this section does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)-16 of Regulations 86 or under article 23 (m)-16 of Regulations 94[1] or under article 23 (m)-16 of Regulations 101[1] or under article 23 (m)-16 of Regulations 103[1] is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1942, or after December 31, 1941, in connection with oil and gas wells. Any taxpayer who has never made expenditures for drilling oil or gas wells prior to the first taxable year beginning after December 31, 1941, must make an election as to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures, and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1941, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (i) in his return for the first taxable year ending after December 31, 1924, in which optional expenditures of the respective types are or were made, or (ii) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4025. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1941, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

[1] 26 CFR, Supp., 3.23 (m)-16; 9.23 (m)-16; 19.23 (m)-16.

(b) *Taxable years beginning after December 31, 1942.* The provisions of this paragraph apply only to taxable years beginning after December 31, 1942.

(1) Items chargeable to capital or to expense at taxpayer's option:

(i) 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 (*a*) in the drilling, shooting, and cleaning of wells; (*b*) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (*c*) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. 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.

(ii) 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 on 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.

(2) Recovery of optional items, if capitalized:

(i) 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 well, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(ii) 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.

(iii) 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.

(iv) 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 taxpayer 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 beginning 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.

(3) Nonoptional items distinguished:

(i) 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.

(ii) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by paragraph (b) of 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.

(4) Paragraph (b) of this section grants a new option with respect to intangible drilling and development costs incurred by an operator in a taxable year beginning after December 31, 1942, in the development of oil and gas properties, and requires a new election under such option. Any operator who incurs such costs must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such costs are incurred. The absence of a clear indication in such return of an election to deduct as expenses intangible drilling and development costs 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. This election is binding for all subsequent years.

§ 29.23 (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 §§ 29.23 (l)-1 to 29.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (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 § 29.23 (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 these regulations shall be interpreted as meaning (1) that the cost or other basis of a mining plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, or (2) that proper deductions for depreciation on account of obsolescence and decay shall not be made during periods when the mine is idle or is producing at a rate below its normal capacity. In estimating the salvage value of the equipment at the end of its estimated economic life due consideration may be given to its specialized character and the cost of dismounting and dismantling and transporting it to market.

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

§ 29.23 (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 § 29.23 (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 §§ 29.23 (l)-1 to 29.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

§ 29.23 (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.

§ 29.23 (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 § 29.113 (b) (1)-1. The apportionment of deductions between the several owners of economic interests in timber properties will be made as specified in § 29.23 (m)-7. The cost of timber properties shall be determined in accordance with the principles indicated in § 29.23 (m)-6. For method of determining fair market value and quantity of timber, see §§ 29.23 (m)-25 to 29.23 (m)-27, inclusive. For depletion purposes the cost of the timber shall not include any part of the cost of the land.

§ 29.23 (m)-21 *Computation of allowance for depletion of timber for given year.* The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber felled during the year and the depletion unit of the timber in the timber account or accounts pertaining to the timber cut. The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (a) the basis, provided by section 113 (a) and adjusted as provided by section 113 (b), of the timber on hand at the beginning of the year plus the cost of the number of units acquired during the year plus proper additions to capital, by (b) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of the number of units of timber cut from the given account during the year multiplied by the depletion unit of the timber for the given account for the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts, see §§ 29.23 (m)-27 and 29.23 (m)-28.

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

§ 29.23 (m)-22 *Revaluation of timber not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit should be changed when a revision of the remaining number of units of recoverable timber in the property has been made in accordance with § 29.23 (m)-26.

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

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

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

In no case may charges for depreciation be based on a rate which will extinguish the cost or other basis of the property prior to the termination of its useful life. Nothing in these regulations shall be interpreted to mean that the value of a timber plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation. (See §§ 29.23 (l)-1 to 29.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

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

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

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

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

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

(e) Record of timber cut;

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

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

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

(i) Unit production costs; and

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

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

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

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

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

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

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

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

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.

§ 29.23 (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.

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

The timber accounts mentioned in the preceding paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this 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.

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

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

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

§ 29.23 (m)-28 *Timber depletion and depreciation accounts on books.* Every taxpayer claiming or expecting to claim a deduction for depletion or depreciation of timber property (including plants, improvements, and equipment used in connection therewith) shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the property, and the plants, improvements, and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments provided by section 113 (b) and §§ 29.113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive.

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 of value shall be allocated to each. (See § 29.23 (m)-27.) These accounts shall be credited with the amount of the depreciation and depletion deductions computed in accordance with § 29.23 (m)-20 each year, or the amount of the depreciation and depletion shall be credited to depreciation and depletion reserve accounts, to the end that when the sum of the credits for depreciation and depletion equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deduction for depreciation and depletion will be allowed.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act, 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

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

(1) The United States, any State, Territory, or any political subdivision thereof or the District of Columbia, 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;

(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, § 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; or

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

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

For unlimited deduction if contributions and gifts exceed 90 per centum of the net income, see section 120.

§ 29.23 (o)-1 *Contributions or gifts by individuals.* A deduction is allowable under section 23 (o) only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A deduction is not allowable, however, for the actual payment of a contribution or gift if the amount of such payment already has been deducted on the accrual basis in computing net income for any taxable year beginning before January 1, 1938. A contribution or gift to 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 computation of deductions for charitable contributions where the taxpayer also has an allowable deduction for medical expenses, see § 29.23 (x)-1.

A contribution or gift to the United States, any State, Territory, or any po-

litical subdivision thereof, or the District of Columbia, or any possession of the United States, exclusively for public purposes, is deductible.

No deduction is allowed in computing the net income of a common trust fund or a partnership for contributions or gifts made to organizations described in section 23 (o). (See sections 169 and 183.) However, a partner's proportionate share of contributions or gifts actually paid by a partnership during its taxable year to such organizations may be allowed as a deduction in his individual personal return for his taxable year with or within which the taxable year of the partnership ends, to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 percent of his net income computed without the benefit of the deduction for contributions. In the case of a nonresident alien individual or a citizen of the United States entitled to the benefits of section 251, see sections 213 (c) and 251. For contributions or gifts by corporations, see § 29.23 (q)-1.

In the case of a 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 15 percent of the aggregate net income of the spouses (computed without regard to such contributions or gifts) as shown by the joint return.

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

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

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

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

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 505 (b), 2d Rev. Act 1940; sec. 10 (b) Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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 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 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 actuarily[1] 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 limitations 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 com-

[1] So in original.

pensation 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.* Any deduction allowable under section 23 (q) of the Revenue Act of 1928 (45 Stat. 802), or the Revenue Act of 1932 (47 Stat. 182), or the Revenue Act of 1934 (48 Stat. 691), under section 23 (p) of the Revenue Act of 1936 (49 Stat. 1661), or the Revenue Act of 1938 (52 Stat. 464), or the Internal Revenue Code for a taxable year beginning before January 1, 1943, which under such section was apportioned to any taxable year beginning after December 31, 1942, shall be allowed as a deduction for the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.

[NOTE: Prior to its amendment by section 162 (b), Rev. Act 1942, section 23 (p) read, as follows:

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

"(2) *Deductions under prior income tax acts.* Any deduction allowable under section 23 (q) of the Revenue Act of 1928, 45 Stat. 802, or the Revenue Act of 1932, 47 Stat. 182, or the Revenue Act of 1934, 48 Stat. 691, under section 23 (p) of the Revenue Act of 1936, 49 Stat. 1661, or the Revenue Act of 1938, 52 Stat. 464, which under such section was apportioned to any taxable year beginning after December 31, 1937, shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.

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

SEC. 162. PENSION TRUSTS. (Revenue Act of 1942, Title I.)

* * * * *

(d) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable as to both the employer and employees only with respect to taxable years of the employer beginning after December 31, 1941, except that—

(1) In the case of a stock bonus, pension, profit-sharing, or annuity plan in effect on or before September 1, 1942,

(A) such a plan shall not become subject to the requirements of section 165 (a) (3), (4), (5), and (6) until the beginning of the first taxable year beginning after December 31, 1942,

(B) such a plan shall be considered as satisfying the requirments of section 165 (a) (3), (4), (5), and (6) for the period beginning with the beginning of the first taxable year following December 31, 1942, and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943.

(C) if the contribution of an employer to such a plan in the employer's taxable year beginning in 1942 exceeds the maximum amount deductible for such year under section 23 (p) (1), as amended by this section, the amount deductible in such year shall be not less than the sum of—

(i) the amount paid in such taxable year prior to September 1, 1942, and deductible under section 23 (a) or 23 (p) prior to amendment by this section, and

(ii) with respect to the amount paid in such taxable year on or after September 1, 1942, that proportion of the amount deductible for the taxable year under section 23 (p) (1), as amended by this section, which the number of months after August 31, 1942, in the taxable year bears to twelve.

(2) In the case of a stock bonus, pension, profit sharing or annuity plan put into effect after September 1, 1942, such a plan shall be considered as satisfying the requirements of section 165 (a) (3), (4), (5) and (6) for the period beginning with the date such plan is put into effect and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943.

* * * * *

§ 29.23 (p)-1 *Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; in general.* 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. Section 23 (p) does not cover contributions or compensation which give the employee or former employee present benefits such as life insurance protection. The cost of such benefits is deductible to the extent allowable under section 23 (a). See § 29.165-6. Section 23 (p), however, is applicable to all contributions under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employee's rights in such contributions are nonforfeitable.

A contribution to be deductible under section 23 (p) must be an ordinary and necessary expense which would be deductible under section 23 (a) if it were not for the fact that the statute specifically provides that it shall be deductible under section 23 (p). A contribution by a corporation under a plan which is created primarily for the purpose of benefiting shareholders of the company is not deductibe. Such contribution may constitute a dividend within the meaning of section 115 (a). A contribution under a plan that is set up for the exclusive benefit of employees as such, and thus represents an item of expense, is of the nature of compensation for personal services rendered by the employees covered by the plan. The amount of contributions allowable as a deduction has an over-all limitation—the entire contributions for the taxable year when added to other compensation paid must represent reasonable compensation for services rendered by the employee beneficiaries. In the case of contributions for pensions for employees, any contributions on behalf of an employee in excess of the amount necessary to provide a reasonable pension for the employee in view of his past and current services is not deductible. What constitutes a reasonable pension will depend upon the facts in the particular case. Compensation otherwise paid the employee, length of service, and retirement age are among the elements to be considered in determining what is a reasonable pension. In the case of a stock bonus or profit-sharing plan which provides for additional compensation for employees not paid as a pension, a contribution will not be fully deductible unless it can be justified as a reasonable addition to the compensation otherwise paid to employees who are beneficiaries under the plan. In addition to the over-all limitation referred to above, section 23 (p) sets forth further limitations as to the amounts that may be deductible for the taxable year.

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, a corporation paying 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 has a plan in effect that is 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.

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.

Any payments shall be disallowed as a deduction under section 23 (p), if determined by the National War Labor Board, the Secretary of Agriculture, or the Commissioner to have been made in contravention of the Act of October 2, 1942, entitled "An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes," as amended (Public Law 729, Seventy-seventh Congress; Public Law 34, Seventy-eighth Congress), or of the regulations, orders, or rulings promulgated thereunder.

§ 29.23 (p)-2 *Information to be furnished by employer claiming deductions.* If a deduction from gross income is claimed under section 23 (p) (1) (A), (B), (C), or (F) the employer must file the following information to establish that the plan or plans meet the requirements of sections 165 (a) or 23 (p) (1) (B), and that the deductions claimed do not exceed the amount allowable under subparagraphs (A), (B), (C), or (F) of section 23 (p) (1), as the case may be:

(a) Verified copies of all the instruments constituting the plan or plans intended to qualify under section 165 (a), including trust indentures, group annuity contracts, and specimen copy of each type of individual contract, with all amendments to any such instruments.

(b) A statement describing the plan or plans which indicates the name or names of the employers, date of inception of each plan, type of administration (whether a trust or insured plan), and a summary of the provisions relating to:

(1) Employee eligibility requirements for participation in the plan,
(2) Employee contributions, if any,
(3) Employer contributions,
(4) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits,
(5) The vesting requirements,
(6) The method of funding, and
(7) The basis of distribution upon liquidation.

(c) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees, listed in the order of their compensation, covered by the plan:

(1) Name.
(2) Whether an officer.
(3) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.
(4) Whether the principal duties consist in supervising the work of other employees.
(5) Year of birth.
(6) Length of service for employer on date of statement.
(7) Total compensation paid or accrued during the taxable year showing separately (i) basic salary, (ii) other direct payments, such as bonuses and commissions, (iii) compensation paid other than in cash, such as goods, services, insurance protection, etc.
(8) Amounts contributed during the taxable year with respect to the employee by the employer under each other plan of deferred compensation.
(9) Amounts paid under the plan during the taxable year by the employer for the benefit of the employee for (i) retirement annuity or other deferred benefits, showing amounts paid for (*a*) past service and (*b*) current service, (ii) life insurance protection, if any, (iii) percentage which each such contribution bears to total of such contributions made for all employees under the plan.
(10) Based on the actuarial method and assumptions used in determining the total employer contributions, the amount of employer liability under the plan (i) with respect to service rendered by the employee prior to the taxable year and (ii) with respect to current service of the employee for the taxable year.
(11) If a pension plan, the amount of benefit to be normally payable annually to each such employee.

(d) The total for items (7) and (8) set forth in paragraph (c) of this section with respect to all of the employees included under the plan and also with respect to all of the employees; also the total for item (9) with respect to all of the employees included under the plan.

(e) A schedule showing the total number of employees as of the close of the taxable year for each of the following groups:

(1) All seasonal and part-time employees excluded under the percentage calculation of section 165 (a) (3) (A) (reasonably estimated).
(2) All employees excluded under the years of service requirement (reasonably estimated).
(3) All employees excluded because older than a maximum age (reasonably estimated).
(4) All employees excluded because younger than a minimum age (reasonably estimated).
(5) All employees excluded because of maximum salary requirement.
(6) All employees excluded solely because of minimum salary requirement and by separate schedule all employees excluded both because of minimum salary requirement and other reason or reasons.
(7) All employees excluded for reasons other than those listed above, specifying reasons.
(8) All employees covered by the plan.
(9) All employees of the employer.

(f) A detailed balance sheet together with or including actuarially determined assets and liabilities, showing equities under insurance or annuity contracts, if any; and a statement of receipts and disbursements during the year.

(g) A statement or schedules showing the valuation assumptions with respect to interest, mortality, turn-over, rate of salary increase, etc., used in determining the costs under the plan. In addition, a statement showing the method of application of such factors to the data, in sufficient detail to permit actuarial analysis as to adequacy thereof and a summary of the total costs claimed, by risk or other pertinent groups, showing the basis for determining the amount of deduction claimed.

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.

The Commissioner may, in addition, require any further information that he considers necessary to establish deductions under section 23 (p), and may waive the filing of such information required herein which he considers unnecessary in the particular case. If the data and information required to be filed under paragraphs (a), (b), and (g) of this section are filed for the first taxable year for which deductions are claimed under section 23 (p), such data and information need not be filed for subsequent years unless a change is made in the plan, instruments, or valuation assumptions described in paragraph (g) of this section, in which case a statement shall be filed at the close of the taxable year showing what changes have been made and the effect thereof. The information required under the other paragraphs of this section shall be filed annually, unless the Commissioner waives the filing of any portion thereof in any particular case.

Records substantiating all data and information specified in this section must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

§ 29.23 (p)-3 *Amounts deductible under a plan in effect on or before September 1, 1942 for a taxable year beginning in 1942.* Section 162 (d) of the Revenue Act of 1942 (set forth immediately preceding § 29.23 (p)-1 allows additional deductions for a taxable year of an employer beginning in 1942 if the deductions are taken under a plan in effect on or before September 1, 1942. For the taxable year mentioned such plan need not meet the requirements of section 165 (a) (3), (4), (5), and (6) of the Internal Revenue Code. See § 29.165-5. If the plan meets the other requirements of section 165 (a) at all times during the taxable year, the employer will be entitled to the amount deductible under section 23 (p), as amended by the Revenue Act of 1942, for such taxable year, or for the amount determined under the following computation, whichever is the greater: The amount paid in such taxable year prior to September 1, 1942, to the extent that such amount is deductible under section 23 (a) and section 23 (p), prior to its amendment by the Revenue Act of 1942, plus such portion of the amount paid on or after September 1, 1942, and deductible under section 23 (p) (1), as amended by the Revenue Act of 1942, which the number of months after August 31, 1942, in the taxable year bears to 12. For ex-

ample, an employer making a return on the calendar year basis paid into a pension trust on March 1, 1942, the sum of $200,000, and on October 1, 1942, he made a further contribution of $100,000. Assume that the total contributions of $300,000 would have been deductible under section 23 (a) and section 23 (p), prior to its amendment by the Revenue Act of 1942, but that only $240,000 thereof is deductible under section 23 (p), as amended by the Revenue Act of 1942, without giving effect to section 162 (d) (1) (C) of the Revenue Act of 1942. A deduction of $280,000 will be allowable for 1942, determined as follows:

Amount contributed prior to September 1, 1942, and deductible under section 23 (a) and section 23 (p), prior to its amendment	$200,000
Pro-rata portion of total 1942 contributions allowed under section 23 (p), as amended (4/12 of $240,000)	80,000
	280,000

§ 29.23 (p)-4 *Contribution of an employer to an employees' pension trust; in general (section 23 (p) (1) (A))*. A contribution of an employer to a pension trust to be deductible under section 23 (p) (1) (A) must be paid within 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 term "pension trust" as used in section 23 (p) (1) (A) means a trust created or availed of by an employer to provide definite actuarially determinable benefits for his employees, which may include former employees, or their beneficiaries, to be paid over a period of years, generally for life, after the retirement of employees, based on service prior to retirement. The retirement benefits may be forfeitable or nonforfeitable. Retirement benefits are basically only life annuities payable after retirement. However, for purposes of this section a retirement benefit may include the following additional benefits: (a) a death benefit, as provided in the plan but not to exceed the excess of the reserve at retirement over the annuity payments received prior to the death of the retired employee (payable either in cash or over a period of years), (b) a benefit upon death or separation from service or upon termination of participation in the plan of an amount as provided in the plan but not to exceed the reserve accumulated for the retirement annuity at the time. Any additional benefits, such as life insurance payments exempt under section 22 (b) (1), will not be considered as part of the retirement annuity for purpose of this section. The cost of such life insurance benefits as distinguished from the cost of an annuity is deductible under section 23 (a) to the extent it is an ordinary and necessary expense, and is includible in the income of the employee as additional compensation in the year or years payments for such life insurance are made. See § 29.165-6. An amount to be deductible under section 23 (p) (1) (A) must also meet the requirements of section 23 (a). It must be an ordinary and necessary expense. See § 29.23 (p)-1. In addition to the requirement that a contribution to be deductible must be an ordinary and necessary expense, the amount of contributions to a pension trust deductible for any taxable year is subject to the further limitations set out in section 23 (p) (1) (A).

In determining allowable deductions all calculations must consider discount for expected mortality and anticipated interest and may consider expected turnover, anticipated salary increases, variable retirement ages, variations in mortality for different classes of risks, other pertinent factors of an actuarial nature, and expenses of operation. In any case, the amount of deduction otherwise allowable for the taxable year shall be reduced by any decrease in liability which may arise from an experience during the next preceding taxable year more favorable than the assumed experience on which the cost calculations were based for each year. In no event shall an interest rate be less than, nor shall any mortality table require premiums greater than, reasonable amounts warranted under the circumstances. In the case of contributions made to a trust where the employer incurs expenses, not payable out of such contributions, such as trustee's fees, actuary's fees, and other expenses, the employer shall be allowed deductions for such expenses under section 23 (a) to the extent they are ordinary and necessary. A properly weighted retirement age determined from reasonable analyses of the experience of the employees included in the plan may be used as the normal retirement age. Different basic assumptions or premium rates may be used for different classes of risks or different groups where such differences are justified by conditions or required by contract, so long as the results of the application thereof are reasonable and do not cause any discrimination.

§ 29.23 (p)-5 *Contributions of an employer to an employees' pension trust; amounts deductible under section 23 (p) (1) (A) (i)*. If the amount of contributions for the first taxable year that section 23 (p) (1) (A) is applicable does not exceed 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees covered by the trust, it will not be necessary for the taxpayer for such taxable year to submit actuarial data to show that such amount is reasonably necessary to provide the remaining unfunded cost of past and current service credits to all employees under the plan. The term "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). However, the Commissioner will make periodical examinations from time to time, at not less than 5-year intervals, and will reduce the amount allowable as a deduction below the 5 percent figure for the years following the taxable year with respect to which the examination is made, if he finds that such percentage is producing contributions in excess of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan.

For the second year and each fifth year thereafter the taxpayer shall submit with his return a certification by a qualified actuary or the company underwriting the pension of the amount determined to be necessary to provide the remaining unfunded cost of past and current service credits. Such certificate shall be accompanied by appropriate supporting data. If the Commissioner determines that the deduction claimed for the taxable year is excessive, the percentage limitation for future years shall be reduced to such amount as may be determined by the Commissioner. During each future year the amount deductible shall be limited to such lower percentage as has been approved by the Commissioner, and no change will be permitted in such percentage until a subsequent actuarial valuation shows such change to be necessary. Such subsequent valuation may be made at any time by the taxpayer and submitted to the Commissioner.

§ 29.23 (p)-6 *Contributions of an employer to an employees' pension trust; amounts deductible under section 23 (p) (1) (A) (ii)*. The level amount or level percentage of compensation under clause (ii) of section 23 (p) (1) (A) may be determined by any reasonable and generally accepted actuarial method selected by the employer. While the need for actuarial calculations is implicit in clause (ii), the statute leaves the determination of specific methods to regulations to be prescribed by the Commissioner with the approval of the Secretary. Clause (ii) must be construed in the light of its obvious relationship to clauses (i) and (iii) and the interplay of clauses (i), (ii), and (iii). Each employer desiring to fund under clause (ii) shall submit the proposed method to the Commissioner and receive approval of such method before the results will be acceptable. Any method which does not fund cost of past service credits more rapidly than that permitted under clause (iii) will be acceptable, and the approval of the Commissioner will not be necessary in such a case.

If the total costs computed under clause (ii) exceed the amount allowable under clause (i), the amount allowable under clause (ii) will be the excess of such total cost over the amount allowable in clause (i). In other words, if a deduction is claimed under clause (ii), the total amount allowable under both clauses (i) and (ii) will be the total cost for the year with respect to either the "level amount" basis or the "level percentage" of payroll basis.

§ 29.23 (p)-7 *Contributions of an employer to an employees' pension trust; amounts deductible under section 23 (p) (1) (A) (iii)*. The basic limitation on deductions for any year under clause (iii) of section 23 (p) (1) (A) is the sum of the "normal" cost, plus an amount equal to one-tenth of the cost of "past service or other supplementary pension or annuity credits" not provided by such "normal" cost.

"Normal cost" for any taxable year is the cost actuarially determined which would be required during such year to maintain the plan assuming that the plan had been in effect from the beginning of the service of each then included employee and that such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Such normal cost may be determined under any reasonable and generally accepted actuarial method and may be expressed either as (a) a level amount or a level percentage of payroll or (b) the total for all of the employees of the single premiums for the unit benefits of each accruing during the year. The method of funding used for determining normal costs must be reasonable and consistent with the provisions of the plan. No method of deteremining normal cost will be permitted which results in discrimination or manipulation.

Past service or supplementary cost at any time is the amount which would be required at such time to meet all the future retirement annuity benefits provided by the plan which will not be met by the expected payments of normal costs and expected future contributions of employees.

§ 29.23 (p)-8 *Contributions of an employer to an employees' pension trust; deduction of excessive amounts paid in a taxable year (section 23 (p) (1) (A) (iv)).* Any amount paid in a taxable year in excess of the amount deductible in such year under clause (ii) or (iii) of section 23 (p) (1) (A) shall be deductible under the provisions of clause (iv) in the succeeding taxable years in order of time to the extent of the difference between the amounts paid and deductible in each such succeeding taxable year and the maximum amounts deductible for such year in accordance with the limitations under clause (ii) or (iii), whichever is applicable. Thus, if the normal cost of the plan required the taxpayer to pay under the plan $100,000 for the taxable year 1942, and he paid $150,000, he would be allowed a deduction of $100,000 for 1942, but if the normal cost continued to be $100,000 for 1943, and he paid in $75,000 that year, he would be allowed a deduction of $100,000 for 1943, and he would be allowed to take the remaining $25,000 in 1944, or for the first succeeding year or years, in which he pays in less than the normal cost for that year.

§ 29.23 (p)-9 *Contributions of an employer toward the purchase of retirement annuities (section 23 (p) (1) (B)).* Section 23 (p) (1) (B) relates to the deduction of amounts paid by an employer for retirement annuities for his employees. If amounts are contributed by an employer to a pension trust and the trust purchases such annuities, the amounts so contributed are deductible under section 23 (p) (1) (A). In order that an employer's payments for retirement annuities may be deductible under section 23 (p) (1) (B), the annuity contracts must be purchased under a plan that meets the requirements with respect to coverage and discrimination in contributions and benefits set out in section 165 (a) (3), (4), (5), and (6). See §§ 29.165-3 to 29.165-5, inclusive. In the case of an annuity plan in effect on or before September 1, 1942, the annuity plan need not meet the requirements of section 165 (a) (3), (4), (5), and (6) except for taxable years beginning after December 31, 1942. (See section 162 (d) of the Revenue Act of 1942, set forth immediately preceding § 29.23 (p)-1.) In addition, no deduction will be allowable for any taxable year under section 23 (p) (1) (B) if any refund of premiums which may be made under the annuity contracts is not applied within the taxable year in which received, or within the next succeeding taxable year, toward the purchase of such retirement annuities for the employees covered under the annuity plan. This provision applies whether the refund is made upon the termination of any annuity contract or prior thereto. If the annuity plan is discontinued, any amount refunded shall be applied during the taxable year of the employer in which the refund is made or during his next succeeding taxable year toward the purchase of annuity contracts for all employees covered by the plan, whether or not the rights of such employees are nonforfeitable. Such refund shall be applied equitably, and, so far as the amount of refund will permit, to the liability under the plan, including contingent liability, with respect to each included employee. See § 29.165-2 for similar requirements upon termination of a pension trust. All amounts refunded under an annuity contract shall be considered a return of premiums to the extent that the amounts recovered do not exceed the total premiums paid. Any amounts credited to an employer under an annuity contract toward the payment of premiums then or thereafter due and which are not refunded, are not required to be credited against the premiums due for the current taxable year or the next succeeding taxable year, but may be credited against premiums due for any taxable year. If under the terms of any annuity contract it is possible for refunds of premiums to be made and not applied within the taxable year in which the refund is received or the next succeeding taxable year toward the purchase of such retirement annuities, no deduction will be allowable under section 23 (p) (1) (B). However, section 23 (p) (1) (B) shall be applicable if under the terms of the annuity contract any refunds are required to be made to a trustee, other than the employer, under an irrevocable trust indenture which provides that such refunds shall be used solely for the payment of premiums for the current year or subsequent years, under the annuity contract.

§ 29.23 (p)-10 *Contributions of an employer to a stock bonus or profit sharing trust (sections 23 (p) (1) (C)).* Section 23 (p) (1) (C) is applicable to contributions of an employer to a stock bonus or profit-sharing trust that meets the requirements of section 165 (a). The contributions to be deductible under this section must be paid in a taxable year of the employer which ends within or with a taxable year of the trust with respect to which the trust is exempt under section 165 (a). Any amount deductible under any of the subdivisions of section 23 (p) (1) (A) is not deductible under section 23 (p) (1) (C), since such amounts represent contributions to a pension trust and not to a stock bonus or profit-sharing trust. As to the types of contributions deductible under section 23 (p) (1) (A), see §§ 29.23 (p)-4 to 29.23 (p)-7, inclusive.

The amount of contributions deductible under section 23 (p) (1) (C) in any taxable year is limited to 15 percent of the compensation otherwise paid or accrued during the taxable year to all of the employees covered by the stock bonus or profit-sharing plan. The term "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). If contributions are made by an employer during a taxable year to two or more stock bonus or profit-sharing trusts, he is limited in his deduction to 15 percent of the compensation otherwise paid or accrued during the taxable year to all of the employees covered by such trusts. If an employer contributes in any taxable year beginning after December 31, 1941, an amount in excess of the maximum amount for which he is allowed a deduction under section 23 (p) (1) (C), such excess shall be deductible in the succeeding taxable years in order of time, but the total amount deductible in any one taxable year shall not exceed 15 percent of the compensation otherwise paid or accrued during such succeeding taxable year to the employees covered by the plan in such year. For example, if an employer pays into a profit-sharing trust during 1943 $100,000, and he is limited to a deduction of $60,000 for such year under the 15 percent limitation provision, and he pays in $70,000 in 1944, although entitled to a deduction of $100,000 for 1944, if he had paid in that amount, nevertheless he will be allowed a deduction of $100,000 for 1944. The remaining $10,000 of the 1943 overpayment not deductible for 1943 or 1944 shall be allowable as a deduction in any succeeding year or years in order of time to the extent that he has not made a contribution of the maximum allowable for such succeeding year or years.

If such contributions are made in any taxable year beginning after December 31, 1941, and such contributions are less than the maximum amount that would have been deductible for such year if contributed, the excess of such maximum amount over the amount actually contributed, or if no amount was contributed, then such maximum amount shall be carried forward and be deductible for the succeeding taxable years, in order of time, but the amount so carried forward shall not be deductible for any taxable year in an amount in excess of 15 percent of the compensation otherwise paid or accrued during such taxable year to the employees covered by the plan. For example, an employer paid into an exempt

profit-sharing trust in 1942 $50,000. Fifteen percent of the total compensation paid or accrued to the employees covered by the trust, not including the amounts contributed to the trust on behalf of such employees, for such year amounted to $150,000. For 1943, 15 percent of such compensation for such employees amounted to $125,000. The employer contributed $200,000 to such a trust during that year. The amount deductible for 1943 is limited by section 23 (p) (1) (C) to $225,000; $125,000 (amount equal to 15 percent of the compensation otherwise paid in 1943) plus $100,000 (amount carried forward from 1942, which amount is not in excess of such 15 percent of such compensation).

§ 29.23 (p)-11 *Contributions of an employer under a plan that does not meet the requirements of section* 165 (a) (*section 23 (p) (1) (D)*). Subparagraph (D) of section 23 (p) (1) 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 § 29.23 (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 individual employees' rights 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 § 29.165-7. If an amount is accrued but not paid during the taxable year, or if paid during the taxable year and the employees' rights are forfeitable at the time the amount is paid, no deduction will be allowed the employer for such amount for such taxable year.

§ 29.23 (p)-12 *Contributions of an employer to two or more employees' trusts, or annuity plans (section 23 (p) (1) (F))*. Section 23 (p) (1) (F) covers cases where an employer makes contributions either to (a) a pension trust and a profit-sharing or stock bonus trust, or (b) a profit-sharing or stock bonus trust and under an annuity plan, or (c) both pension and profit-sharing or stock bonus trusts and under an annuity plan, and such contributions are made under a plan or plans that meet the requirements of section 165 (a). It does not cover cases where an employer makes contributions to two or more pension trusts or to a pension trust and under an annuity plan or plans. In such cases deductions are determined under section 23 (p) (1) (A) if made under a plan that meets the requirements of section 165 (a) or, if not meeting such requirements, then under section 23 (p) (1) (D). Neither is it applicable to a case where there are only two or more stock bonus or profit-sharing trusts. See § 29.23 (p)-10. If no employee is a beneficiary under more than one trust, or a trust and an annuity plan, section 23 (p) (1) (F) is not applicable.

The amount deductible under section 23 (p) (1) (F) is limited to 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees covered by the plans. The term "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). If an employer contributes an amount under such plans in excess of the 25 percent limitation, he shall be allowed deductions for such excess in the succeeding years in order of time but limited in amount in any one year so that the total amount allowable under section 23 (p) (1) (F) for any one taxable year shall not exceed 30 percent of the compensation otherwise paid or accrued during such taxable year to the employees covered by the plans. For example, if an employer on the calendar year basis contributed during 1942 to pension and profit-sharing trusts amounts equal to 40 percent of the compensation otherwise paid employees covered by the plans, and in 1943 contributed to such trusts an amount equal to 25 percent of such compensation, he would be allowed a deduction for 1943 for the excess for which no deduction was allowable for 1942 plus the amount otherwise allowable for 1943 in an aggregate amount not in excess of 30 percent of the compensation otherwise paid such employees for 1943. If there remained a portion of such excess for which no deduction was allowable for 1943, such portion could be carried over to 1944 and succeeding taxable years, subject to the 30 percent limitation.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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, 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 the date of the cessation of hostilities in the present war, as proclaimed by the President, 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;

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.

§ 29.23 (q)-1 *Contributions or gifts by corporations.* A corporation may deduct from its gross income contributions or gifts to organizations described in section 23 (q) (see § 29.22 (b) (4)-1 for definition of "political subdivision"). Where payment is made in a taxable year beginning prior to the first taxable year beginning after the date of the cessation of hostilities in the present war, as proclaimed by the President, the charitable deduction prescribed is allowable to corporations even though the gifts or contributions are used outside of the United States or its possessions. Such deduction shall, to the extent provided by that section, 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 § 29.23 (a)-13. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses are not deductible from gross income.

The provisions of the last paragraph of § 29.23 (o)-1, relating to (1) the statement in returns of the name and address of each organization to which a contribution or gift was made and the amount and the approximate date of the actual payment of the contribution or gift, (2) the substantiation of the claims for deductions when required by the Commissioner, and (3) the basis for calculation of the amount of a contribution or gift which is other than money, are equally applicable to claims for deductions of contributions or gifts by corporations under section 23 (q).

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

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

(s) *Net operating loss deduction.* For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(t) *Amortization deduction.* The deduction for amortization provided in section 124.

(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. [NOTE: Under section 120 (g) of the Revenue Act of 1942, this provision is applicable only with respect to taxable years beginning after December 31, 1941; except that if the first taxable year beginning after December 31, 1941, of the husband does not begin on the same day as the first taxable year beginning after December 31, 1941, of the wife, this provision shall first become applicable in the case of the husband on the first day of the wife's first taxable year beginning after December 31, 1941, regardless of the taxable year of the husband in which such day falls.]

§ 29.23 (u)-1 *Periodic alimony payments.* 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 § 29.22 (k)-1. (For definition of husband and wife in such cases, see section 3797 (a) (17).)

The deduction is allowed only for such amounts as are actually paid on or after January 1, 1942, in a taxable year of the wife or former wife beginning after December 31, 1941. For this purpose, the taxpayer is treated as if he makes his income tax returns on the cash receipts and disbursements basis, regardless of the method of accounting actually employed by him in making such returns.

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.

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 1940, transfers securities valued at $100,000 in trust for the benefit of W, which fully discharges all his obligations to W. For 1942 and thereafter 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 1942 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 1942. (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 for $1,000 under the provisions of section 23 (u).

For other examples, see § 29.22 (k)-1.

[SEC. 23. DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941; secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 158 (b), 162 (b), Rev. Act 1942.]

[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.

(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). [NOTE: Subsection (w) is, under sec. 134 (f), Rev. Act 1942, applicable only with respect to taxable years ending after December 31, 1942.]

(x) *Medical, dental, etc., expenses.* Except as limited under paragraph (1) or (2), 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) (2) (A) of the taxpayer. 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).

(1) A husband and wife who file a joint return may deduct only such expenses as exceed 5 per centum of the aggregate net income of such husband and wife, computed without the benefit of this subsection, and the maximum deduction for the taxable year shall be not in excess of $2,500 in the case of such husband and wife.

(2) An individual who files a separate return may deduct only such expenses as exceed 5 per centum of the net income of the taxpayer, computed without the benefit of this subsection, and the maximum deduction for the taxable year shall be not in excess of $2,500 in the case of the head of a family, and not in excess of $1,250 in the case of all other such individuals.

§ 29.23 (x)-1 *Medical, dental, etc., expenses.* 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, 1942, but not paid until January, 1943, no deduction can be taken for the year 1942.

The expenses paid must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer (see § 29.25-6 for description of dependents), not compensated for by insurance or otherwise. 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 so received must be included in the gross income of the taxpayer for the taxable year received to the extent 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, the portion of the compensation so received which is attributable to the deduction taken is that proportion of such compensation which the amount of the deduction bears to the total amount of the payments made in the prior year not compensated for during such prior year.

It is unnecessary for the purposes of this section that the spouse or dependent of the taxpayer for whom the medical expenses are paid be such at the time of payment, or at the time they were incurred. Thus, payments made in June, 1942, by A, for medical services rendered B, his wife, in 1941, may be deducted by A for 1942 even though prior to payment for that year B died or secured a divorce; and payments made in July, 1942, by C for medical services rendered D in 1941 may be deducted by C for 1942 even though C and D were not married until June, 1942.

Only such medical expenses are deductible as exceed 5 percent of the net income computed without the deduction for medical expenses. Where a taxpayer has allowable deductions in the taxable year for both charitable contributions and medical expenses the allowable deductions for charitable contributions should be computed first, without regard to deduction for medical expenses, and thereafter the deduction for medical expenses should be calculated (see § 29.23 (o)-1). The maximum deduction allowable for medical expenses paid in any one taxable year is $2,500 in the case of the head of a family or a husband and wife filing a joint return. In all other cases, the maximum is $1,250.

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-rays 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 taxpaper), medical, laboratory, surgical, dental and other diagnostic and healing services, 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.

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 deduction must be substantiated, when requested by the Commissioner, by a statement from the individual or entity to which payment for medical expenses was paid 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.

The application of section 23 (x) and this section may be illustrated by the following example:

Example. Taxpayer A, divorced from B in December 1941 and having one dependent child, had net income for 1942 of $3,000 before deduction of medical expenses. During 1942 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation in September 1941 on B, his wife at the time of the operation. In 1942 he received a payment of $50 for health insurance covering B's illness during 1941.

The deduction allowable under section 23 (x) for the calendar year 1942 is $100, computed as follows:

Payment for medical care in 1942	$300
Less: Amount of insurance received in 1942	50
Payment for medical care in 1942 not compensated for during 1942	250
Less: 5 percent of $3,000 (net income before deduction of medical expenses)	150
Excess, allowable as deduction for 1942	100

Assuming in the above example that, in 1943, A brings suit and receives $150 upon a hospital insurance policy covering the expenses incurred by B in 1941, the amount included in taxable income for 1943 is $60, computed as follows (see section 22 (b) (5)):

Compensation received in 1943	$150
Less: Portion thereof attributable to the deduction allowed for prior year 1942: 100 (deduction for 1942) / 250 (payments not compensated for in 1942) × $150 (compensation received in 1943)	60
Amount to be excluded from gross income for 1943	90
Taxable income for 1943	60

[SEC. 23 DEDUCTIONS FROM GROSS INCOME—as amended by secs. 211 (a), 224, Rev. Act 1939; secs. 301, 506 (b), 2d Rev. Act. 1940; sec. 10 (b), Excess Profits Tax Amendments 1941; sec. 202 (a), Rev. Act 1941, secs. 105 (c), 120 (b), 121 (a) (c), 122, 123 (a), 124 (a), 125, 126 (a), 127 (a) (c), 128, 134 (d), 163 (b), 162 (b), Rev. Act 1942.]

[In computing net income there shall be allowed as deductions:]

(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) *Definitions.* 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.

§ 29.23 (z)-1 *Amounts representing taxes and interest paid to cooperative apartment corporation.* 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 prior to the close of the taxable year of the tenant-stockholder, or of the interest paid or incurred by the corporation prior to 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.

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.

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 apart-

ment. 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.

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.

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

Example (1). The X Corporation is, and at all times since 1940 has been, a cooperative apartment corporation within the meaning of section 23 (z). In 1940 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, who each 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 1940 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 basis. In 1941 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 1942, 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 1941 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $900 in computing his net income for 1942. 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 share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		900
A's proportionate share 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 1941; 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 1942 is $1,140 instead of $1,380; and more than 80 percent of the gross income of the corporation for 1941 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $743.48 in computing his net income for 1942. 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 share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate share 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 1942.

Example (3). The facts are the same as in example (2) except that the amount paid by A to the X Corporation in 1942 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 1942. The deduction is computed as follows:

Total amount paid by A	$1,000.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate share 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 1942.

SEC. 24. ITEMS NOT DEDUCTIBLE [as amended by secs. 121 (b), 127 (b), 129, 130 (a), Rev. Act 1942].

(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;

(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 chargable 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.

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

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

(1) If such expenses or interest are not paid within the taxable year or within two and one half months after the close thereof; and

(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

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

(d) *Holders of life or terminable interest.* Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this 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.

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

§ 29.24-1 *Personal and family expenses.* Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives clients, patients, or callers there in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is deductible. If the father is entitled to the services of his minor children, any allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. Amounts paid as damages for breach of promise to marry, attorneys' fees and other costs of suit to recover such damages, and attorneys' fees paid in a suit for separation are not deductible from gross income. 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) and § 29.23 (x)-1.

§ 29.24-2 *Capital expenditures.* Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities 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. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See § 29.22 (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.

§ 29.24-3 *Premiums on business insurance.* Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is not a beneficiary under such a policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. (See §§ 29.22 (a)-3 and 29.23 (a)-6 to 29.23 (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 § 29.22 (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 §§ 29.22 (b) (1)-1 and 29.22 (b) (2)-3.)

§ 29.24-4 *Amounts allocable to exempt income, other than interest*—(a) *Class of exempt income.* 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. The term "taxable income" as used in this section 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.

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.* 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 sums, directly attributable to any class or classes of exempt income, shall be allocated thereto; and items, or parts of such items, directly attributable to any class or classes of taxable income, shall be allocated thereto.

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

(c) *Statement of items of exempt income, records.* A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (1) the amount of each class of exempt income, and (2) the amount of items, or parts of items, allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (b) 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. The taxpayer shall keep such records as will enable him to make the allocations required by this section (see section 54).

§ 29.24-5 *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) 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 acount 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.* 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:

(1) In the case of unimproved and unproductive real property, annual taxes, interest on a mortgage, and other carrying charges;

(2) 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);

(3) 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.

(4) 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.

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 of items of that type.

Once, however, such an election is made under subparagraph (2), (3), or (4), above, 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 paragraphs, 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 (2) 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 (3) this term means the act of transporting, installing, or putting into use of the machinery or other fixed assets. An election under subparagraph (1), 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.

Example (1). A in 1942 and 1943 pays annual taxes and interest on a mortgage on a piece of vacant and unproductive property. Throughout 1943 he operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1942 but not the taxes and mortgage interest paid in 1943.

Example (2). X began in February, 1942, the erection of a building for himself. X in 1942 paid $6,000 social security taxes in connection with the erection of the building, which in his 1942 return he elected to capitalize. X must continue to capitalize the social security taxes paid in connection with the erection of this building until its completion in 1944.

Example (3). Assume the facts in example (2) except that in November, 1942, X also begins to build a hotel which will be completed in 1945. In 1942 X pays $3,000 social security taxes in connection with the erection of the hotel. X is not bound by the election to capitalize exercised in connection with the social security taxes paid in erecting the building started in February, 1942, but may deduct the $3,000 social security taxes.

Example (4). X in 1942 began the erection of a building for himself, which would take three years to complete. X in 1942 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 1943 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.

The sole effect of section 24 (a) (7) is to permit such items to be properly 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 were 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 have the effect of disallowing an item to be 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 so under section 23 (such, for example, as salaries or other compensation paid or incurred for services rendered in the construction of property.)

In the absence of 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 § 29.23 (m)-16, making intangible drilling and development costs chargeable to capital or to expenses at the taxpayer's option and § 29.23 (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 option to treat as a capital item or as an allowable deduction 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 1942 pays its general manager, B, a salary of $4,000 and social security taxes of $90 measured thereby. 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 $9 of the $90 social security taxes.

§ 29.24-6 *Losses from sales or exchanges between certain classes of persons*—(a) *Individuals (including fiduciaries).* In the case of sales or exchanges of property, directly or indirectly, between individuals (including fiduciaries) section 24 (b) (1) provides that no deduction shall be allowed with respect to losses arising therefrom in the following cases: (1) between members of a family as defined in section 24 (b) (2) (D); (2) between fiduciaries of trusts having a common grantor; (3) between a grantor and a fiduciary of the same trust; or (4) between a fiduciary of a trust and a beneficiary of such trust.

(b) *Corporations (including shareholders).* In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24 (b) (1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual shareholder (see section 24 (b) (1) (B) or between two corporations (see section 24 (b) (1) (C)). Under section 24 (b) (1) (B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. Under section 24 (b) (1) (C), however, as provided therein, not only must more than 50 percent in value of the outstanding stock of each of such corporations be owned, directly or indirectly, on the date of the sale or exchange by or for the same individual, but one of the corporations must be either a personal holding company as defined in section 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, 1942, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1941 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, 1942, 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, 1942, 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, 1942, 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).

§ 29.24-7 *Disallowance of deductions for unpaid expenses and interest.* The application of section 24 (c) may be illustrated by the following example:

Example. A is the holder and owner of an interest-bearing note executed by the M Corporation all of the stock of which is owned by him. A and the M Corporation make their income returns on the basis of a calendar year but the M Corporation makes its returns on the accrual basis and A makes his returns on the cash receipts and disbursements basis. The M Corporation does not pay any interest on such note during the calendar year 1942 or within two and one-half months after the close thereof, but claims a deduction for the year 1942 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 1942. 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 1942. The provisions of such section 24 (c) do not otherwise affect the general rules governing the allowance of deductions under the accrual basis. Hence, in the event the M Corporation should pay such interest after March 15, 1943, no deduction therefor would be allowable in computing its net income for the year in which the payment was made.

§ 29.24-8 *Life or terminable interests.* Amounts paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time. (See section 113 (a) (5).)

No deductions shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, if the estate or trust is entitled to a deduction under 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.

§ 29.24-9 *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.

SEC. 25. CREDITS OF INDIVIDUAL AGAINST NET INCOME [as amended by sec. 6 (a), Rev. Act 1940; secs. 111 (a), 113, Rev. Act 1941; secs. 112 (b), 120 (e), 126 (i), 131 (a) (b), Rev. Act 1942].

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

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

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

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

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

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

(1) *Personal exemption.* In the case of a single person or a married person not living with husband or wife, a personal exemption of $500; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $1,200. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $1,200. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them.

(2) *Credit for dependents*—(A) *Allowance in general.* $350 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective. 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.

(B) *Exception for certain heads of families.* If the taxpayer would not occupy the status of head of a family except by reason of there being one or more dependents for whom he would be entitled to credit under subparagraph (A), the credit under such subparagraph shall be disallowed with respect to one of such dependents.

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

§ 29.25-1 *Credits of individual against net income.* For the purpose of computing the normal tax the taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is first reduced by the sum of the allowable credits. These include interest exempt from normal tax only (and hence included in gross income) received upon (1) obligations of the United States and (2) obligations of corporations organized under Act of Congress which are instrumentalities of the United States; an earned income credit; a personal exemption; and a credit for dependents. (See section 22 (b) (4).) For the purpose of computing the surtax the taxpayer's net income is entitled to none of these credits, except the credit for personal exemption and credit for dependents.

§ 29.25-2 *Earned income credit.* Under section 25 (a) (3) the earned income credit allowable for the purpose of computing the normal tax is 10 percent of the amount of the earned net income, but not in excess of 10 percent of the amount of the entire net income.

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

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

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

Example (1). An individual received income from interest on bonds during the calendar year 19424 amounting to $6,000. His allowable deductions under section 23 for that year amounted to $2,000. He is entitled to an earned income credit of $300, computed as follows:

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

Example (2). An individual received a salary of $20,000 as a traveling salesman for the calendar year 1942. His allowable deductions under section 23 for that year amounted to $12,000, of which $2,000 was for traveling expenses in the course of his business and $10,000 was for a loss of his home from fire. His net income is $20,000 minus $12,000, or $8,000. He is entitled to an earned income credit of $800, computed as follows:

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

Example (3). During the calendar year 1942 an individual was engaged in a business in which both personal services and capital were income-producing factors. A reasonable allowance as compensation for the personal services actually rendered by the taxpayer in the conduct of the business for that year was $10,000. The net profits of the business were $35,000, which constituted his net income for the year. He is entitled to an earned income credit of $700, computed as follows:

Earned income before applying limitation in section 25 (a) (4) (A)	$10,000
Earned income as limited by section 25 (a) (4) (A) (20 percent of $35,000)	7,000
Earned income credit allowable (10 percent of $7,000)	700

In the case of a husband and wife making a joint return, there is but one earned income credit, computed upon the combined income of the spouses, and the maximum and minimum limitations prescribed with respect to such credit shall be based upon the combined income as if the joint return were the return of one individual.

§ 29.25-3 *Amount of personal exemption allowable.* A single person or a married person not living with husband or wife is entitled to a personal exemption of $500, and the head of a family or a married person living with husband or wife is entitled to a personal exemption of $1,200. A husband and wife living together have but one personal exemption, which is $1,200. If they make separate returns, each may claim one-half of the personal exemption, or such exemption may, in accordance with an agreement entered into by them, be taken by either or divided between them in any proportion. With regard to returns by husband and wife under Supplement T, see section 404.

§ 29.25-4 *Personal exemption of head of family.* A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. In the case of spouses who are divorced or legally separated under a decree of divorce or of separate maintenance, periodic payments (in the nature of, or in lieu of, alimony or an allowance for support) received by one spouse which she is required under section 22 (k) or section 171 (a) to include in her gross income and which she uses for support of dependents are considered payments by her for such support and not payments by the other spouse for support of any person. In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the Internal Revenue Code must depend on the character of the separation. If a father is absent on business, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not thereby entitled to credit as the head of a family. As to the amount of the exemption, see § 29.25-3.

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

§ 29.25-6 *Credit for dependents.* A taxpayer, other than a nonresident alien who is not a resident of Canada or Mexico (see section 214), receives a credit of $350 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under 18, or (b) incapable of self-support because defective. For credit for dependents in computing tax under Supplement T, see sections 400 and 401.

The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit. In the case of spouses who are divorced or legally separated under a decree of divorce or of separate maintenance, payments (in the nature of, or in lieu of, alimony or an allowance for support) received by one spouse which she is required under section 22 (k) or section 171 (a) to include in her gross income and which she uses for support of dependents are considered payments by her for such support and not payments by the other spouse for support of any person.

If a taxpayer occupies the status of the head of a family solely by reason of the existence of one or more dependents for whom he would be entitled to credit under section 25 (b) (2) (A) were it not for section 25 (b) (2) (B), the credit in respect of one of such dependents is disallowed. For example, a widower who occupies the status of the head of a family solely by reason of the fact that he is maintaining a home for two dependent children under 18 years of age is entitled to the credit of $350 allowed for one such dependent, and the credit for the other dependent is disallowed. If, however, in addition to the two dependent children under 18 years of age, the widower also supports and maintains in the home a child who is over 18 years of age and who is not mentally or physically defective, he is entitled to a credit of $350 for each of the two children under 18 years of age, since his support and maintenance of the child over 18 years of age is in itself sufficient to give him the status of head of a family, and therefore he does not occupy such status solely by reason of the existence of dependent children under 18 years of age.

§ 29.25-7 *Personal exemption and credit for dependents where status changes.* If the status of the taxpayer changes during the taxable year, the personal exemption allowed by section 25 (b) (1) to a single person, a married person not living with husband or wife, a head of a family, or a married person living with husband or wife, and the credit for dependents allowed by section 25 (b) (2) will be apportioned according to the number of months during which the taxpayer occupied each status. A taxpayer not having the status of a head of a family or the status of a married person living with husband or wife shall be considered as having the status of a single person. For the purpose of

the apportionment of the personal exemption and credit for dependents a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month. In general, the personal exemption and credit for dependents allowable to any taxpayer will be the sum of the amounts apportioned to the several periods of the taxable year during which each status was occupied.

The return for the period in which falls the date of the death of a taxpayer is a return only for the period during which the taxpayer was alive. The personal exemption and credit for dependents must be determined on the basis of the period for which the return was made. If during such period the status of the taxpayer did not change, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in such period bears to 12 months. See § 29.47-1. If the status of the taxpayer changed during such period, the full personal exemption and credit for dependents allowable for each status occupied by the taxpayer shall be apportioned to the period during which such status was occupied in such proportion as the number of months during which such status was occupied bears to 12 months.

Example (1). A and B, who were heads of families during the first six months of 1942, were married on July 1, 1942, and lived together during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1942, the personal exemption will be $1,800; that is, ½ of $1,200 for A while the head of a family, plus ½ of $1,200 for B while the head of a family, plus ½ of $1,200 for the period during which they were married and living together. If separate returns are made by A and B on the calendar year basis for 1942, each may claim a personal exemption of $900; that is, ½ of $1,200, plus ½ of ½ of $1,200. In the latter case, however, the joint exemption of ½ of $1,200 might by agreement be taken either by A or B or divided between them in any proportion.

Example (2). A, a widower, qualifies as the head of a family until March 31, 1942, on which date his one dependent child died. On September 30, 1942, A dies. The executor or administrator making a return for A may claim a personal exemption of $550; that is, 3/12 of $1,200, or $300, for the period from January 1, 1942, to March 31, 1942, during which period A was the head of a family, and 6/12 of $500 or $250, for the period from April 1, 1942, to September 30, 1942, during which period A was a single person not the head of a family.

Example (3). A and B were married and living together until November 30, 1942, when B, the wife, died. They had no dependents. The taxable period of B is January 1, 1942, to November 30, 1942, the date of her death. The combined personal exemption of A and B for the period during which they were married and living together, that is, 11/12 of $1,200, or $1,100, may by agreement be taken either by A, or by B's executor or administrator in behalf of B, or divided between them in any proportion. The personal exemption for the last taxable period of B is the amount of the combined personal exemption so taken by B's executor or administrator. If A, the surviving spouse, files a return for the calendar year 1942, he may claim, in addition to his portion of the combined personal exemption, a personal exemption for the period from the date of the death of B to the close of his taxable year, that is, 1/12 of $500.

Example (4). A and B were married and living together until June 30, 1942, when A, the husband, died. Prior to the date of death, A was the chief support of a child 10 years of age. B, the surviving spouse, supported and maintained the child in her household during the remainder of the year. The executor or administrator in making a return for A is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $175; that is, 6/12 of $350. However, since B qualifies as head of a family for the the last six months solely by reason of the fact that she maintained a home for such dependent child, the credit for such dependent is disallowed.

SEC. 26. CREDITS OF CORPORATIONS [as amended by sec. 211 (j), Rev. Act 1939; secs. 105 (d) (e), 126 (i), 132 (a), 133, Rev. Act 1942].

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).

(b) *Dividends received.* 85 percentum of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter, but not in excess of 85 per centum of the adjusted net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in subsection (e). The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, 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.

(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 (if beginning after December 31, 1937), 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.

In the case of a taxable year beginning after December 31, 1937, and before January 1, 1939, the term "net operating loss" means net operating loss as defined in section 26 (c) of the Revenue Act of 1938, 52 Stat. 467.

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

(e) *Income subject to excess-profits tax.* In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 90 per centum. For the purpose of the preceding sentence the term "tax imposed by Subchapter E of Chapter 2" means the tax computed without regard to the limitation provided in section 710 (a) (1) (B) (the 80 per centum limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727.

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

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

(h) *Credit for dividends paid on certain preferred stock*—(1) *Amount of credit.* In the case of a public utility, the amount of dividends paid during the taxable year on its preferred stock. 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 and section 15 (a)—

(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.

§ 29.26-1 *Credit of corporation for interest on obligations of the United States and its instrumentalities.* The credit

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

§ 29.26-2 *Credit of corporation for net operating loss of preceding year.* Since the net operating loss credit allowed by section 26 (c) cannot exceed (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 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 cases 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.

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 § 29.23 (m)-2). The basis for such depletion is the basis provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain upon the sale or other disposition of the property involved.

In computing deductions for the preceding taxable year the net operating loss provided in section 122 shall not be allowed.

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.

Example. For 1942 the X Corporation, which makes its income tax returns on the calendar year basis, has a net income of $1,000,000, 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 1942, not allowable as a deduction under section 23, are $300,000, and it made no contributions during that year. For 1941 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, 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 1941 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 1942 is computed as follows:

Deductions for 1941		$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	
Less net operating loss deduction	500,000	
		700,000
Deductions as limited by section 26 (c) (2) (A) and 26 (c) (2) (C)		800,000
Gross income for 1941	$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 1941		200,000
Net income for 1942 (computed without net operating loss deductions provided in section 23 (s))		1,000,000
Less capital losses not allowed by section 117 (d)	$550,000	
Less Federal normal tax and surtax for 1942 not allowed as a deduction under section 23	300,000	
		850,000
Section 102 net income for 1942		150,000

The credit for the net operating loss for the preceding year available to the X Corporation for 1942 is $150,000. Inasmuch as the excess of deductions over gross income for 1941, as computed above, is greater than the section 102 net income for 1942 the net operating loss credit available to the X Corporation for 1942 is equal to the section 102 net income for 1942. If the excess of deductions over gross income for 1941, as computed above, were smaller than the section 102 net income for 1942, the entire amount of such excess would be allowed as the net operating loss for 1942.

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.

§ 29.26-3 *Bank affiliates.* The credit provided in section 26 (d) is allowed:

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

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

(c) 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 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 section 5144 to the acquisition of readily marketable assets other than bank stock.

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

§ 29.26-4 *Credit for income subject to excess profits tax.* A credit is provided in section 26 (e) allowable under sections 13 (a) (2) and 15 (a) in computing normal tax net income and surtax net income, respectively. See section 108 as to certain fiscal years. The credit is allowed only in the case of corporations subject to the excess profits tax imposed by subchapter E of chapter 2. The credit does not apply to a corporation exempt from such tax under section 725 (relating to personal service corporations) or section 727 (relating to corporations exempt from excess profits tax).

In general, the credit is the amount of the corporation's adjusted excess profits net income, as defined in section 710 (b). In the case of the following corporations, however, the credit is an amount of which the tax imposed by subchapter E of chapter 2 is 90 percent:

(a) Corporations computing such excess profits tax under section 721, relat-

ing to abnormalities in income in the taxable period.

(b) Corporations computing such excess profits tax under section 726, relating to corporations completing contracts under the Merchant Marine Act of 1936.

(c) Corporations computing such excess profits tax under section 731, relating to corporations engaged in mining strategic minerals.

(d) Corporations computing such excess profits tax under section 736 (b), relating to corporations with income from long-term contracts.

For the purpose of the credit in the case of such corporations, the excess profits tax (upon which the credit is to be computed) is the tax imposed under subchapter E of chapter 2 computed without regard to the limitation of tax to 80 percent of surtax net income, as provided in section 710 (a) (1). The excess profits tax is also determined for this purpose without regard to any credit for foreign taxes allowed in section 729 (c) and (d) and without regard to the adjustments provided in section 734.

The determination of this credit may be illustrated by the following example:

Example. The X Corporation is a domestic corporation computing its excess profits tax under section 731. It makes its income tax returns on the calendar year basis. The portion of its excess profits net income attributable to mining in the United States of platinum (a strategic mineral) is $60,000 and the remainder is attributable to other activities. For 1942, its total excess profits net income is $120,000 and its adjusted excess profits net income is $50,000. The portion of the adjusted excess profits net income subject to excess profits tax is $25,000 $\left(\frac{60,000}{120,000} \text{ of } \$50,000\right)$ The tax (computed without regard to section 731) on $50,000 under section 710 (a) (1) (A) (90 percent rate) is $45,000. The tax under section 731 is $\frac{25,000}{50,000}$ of $45,000, or $22,500. Accordingly, the credit under section 26 (e) is $25,000, the amount of which such $22,500 tax is 90 percent.

If the excess profits tax of a corporation imposed by subchapter E of chapter 2 for a taxable year beginning after December 31, 1941, is finally determined by the use of the excess profits credit based upon constructive average base period net income determined under section 722 or if the corporation is entitled to and uses such excess profits credit in the computation of its excess profits tax for such year without the necessity of filing an application for relief under section 722 (see § 30.722-5 (e) of this chapter), the credit under section 26 (e) allowable in computing the normal tax and surtax shall be the amount of the corporation's adjusted excess profits net income, as defined in section 710 (b), computed with the use of the excess profits credit based upon constructive average base period net income. However, if such corporation computes its excess profits tax as provided in (a), (b), (c), or (d) of this section, the credit under section 26 (e) shall be the amount of which the tax imposed by subchapter E of chapter 2, computed as provided by the second paragraph of this section, is 90 percent.

§ 29.26-5 *Credit for dividends paid on preferred stock of public utilities.* The credit provided in section 26 (h) is an amount equal to the dividends paid during the taxable year by certain public utility corporations on certain classes of preferred stock. As used in this section, 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 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.

For the purposes of section 26 (h) 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 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.

The amount allowable as a credit under section 26 (h) shall be subtracted from the basic surtax credit otherwise computed under section 27 (b).

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT [as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942].

(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) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1939), exceeds the amount of the credit provided in section 26 (c) (relating to net operating losses), for such preceding taxable year (if beginning after December 31, 1937); and

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

§ 29.27 (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).

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

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

§ 29.27 (a)-2 *Deficit credit.* Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits as of the close of the preceding taxable year over the net operating loss credit allowed by section 26 (c) for such preceding taxable year.

A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits,

however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. It is the subsequent operating loss, however, and not the distribution which creates the deficit. For example, the X Corporation, which makes its income tax returns on the calendar year basis, has on January 1, 1942, accumulated earnings and profits of $100,000. During 1942 there are no further earnings and profits. On February 1, 1942, operating losses have reduced the accumulated earnings and profits account to $50,000. On March 1, 1942, $90,000 is distributed to shareholders. On April 1, 1942, an operating loss of $40,000 is incurred. There is no further change during the taxable year. Though the corporation closes its year with total assets of $180,000 less than it had on January 1, 1942, and $90,000 of that amount was attributable to operating losses, only $40,000 constitutes a deficit in accumulated earnings and profits as of the close of the year. If, however, no operating losses were incurred up to February 1, $90,000 was distributed to shareholders on February 1, a $50,000 operating loss was incurred on March 1, and a $40,000 operating loss on April 1, the corporation's deficit in accumulated earnings and profits would be $80,000 as of the close of the year.

§ 29.27 (a)-3 *Amounts used or irrevocably set aside to pay or to retire indebtedness*—(a) *Indebtedness.* The term "indebtedness" means an obligation of a corporation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount, existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on December 31, 1937. If the indebtedness was so evidenced at the close of business on December 31, 1937, it is still an indebtedness within the meaning of section 27 (a) (4) though, prior to the time payment is made or amounts are irrevocably set aside, it has been renewed. Such renewal need not be evidenced by one of the types of instruments enumerated in section 27 (a) (4), but it is sufficient if the debtor-creditor relationship evidenced by one of such instruments at the close of business on December 31, 1937, continues. An indebtedness once so renewed may be again renewed without depriving the corporation of the benefits of section 27 (a) (4). Indebtedness incurred after December 31, 1937, is not indebtedness within the meaning of section 27 (a) (4) even though the proceeds of the loan are used to discharge an indebtedness falling within the provisions of that section, as, for example, where money is borrowed from A to pay B, but, if the creditor remains the same and the transaction is in effect a renewal, the mere fact that it takes the form of a new borrowing, the proceeds of which are simultaneously used to discharge the prior obligation, will not of itself prevent the transaction from being a renewal within the meaning of section 27 (a) (4) and this section.

The mere substitution, after December 31, 1937, of several instruments for one instrument, or one instrument for several instruments, existing at the close of business on such date, where there is no change in terms except the substitution of a series of different amounts equal in the aggregate to the total principal amount of the instrument or instruments surrendered (as, for example, where two $50,000 bonds are issued in exchange for one $100,000 bond, or where one $100,000 bond is issued in exchange for two $50,000 bonds), or the reissue of a lost or destroyed instrument, or the issue of a new instrument to a transferee, will not deprive a corporation of the benefits of section 27 (a) (4).

Indebtedness incurred through the assumption of the liabilities of another is not indebtedness within the meaning of section 27 (a) (4) unless such assumption took place prior to January 1, 1938, and such indebtedness was evidenced at the close of business on December 31, 1937, by one or more of the instruments enumerated in such section, issued by the taxpayer prior to, and in existence at, the close of business on such date.

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

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

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

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

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

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(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.

§ 29.27 (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.

§ 29.27 (b)-2 *Dividends paid*—(a) *When dividends are considered paid.* A dividend will be considered as paid when it is received by the shareholder. An allowance for dividends paid will not be permitted unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

The payment of a dividend during the taxable year to the authorized agent of the shareholder will be deemed payment of the dividend to the shareholder during such year.

If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the allowance for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

An allowance will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

In the case of a stock dividend, if the shares (other than fractional shares payable to bearer) constituting the dividend are not entered or registered on the books of the corporation in the name of the shareholder (or his nominee or transferee) within the taxable year, the dividend will not be deemed to have paid in such year. Delivery of a certificate, or certificates, for such new shares, within the taxable year, constitutes prima facie evidence of the payment of the dividend.

If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee), to constitute payment of the dividend within the taxable year.

In the case of a dividend from which the tax has been deducted and withheld as required by section 143 or 144, the dividend is considered as paid when such deducting and withholding occur.

(b) *Methods of accounting.* The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the net income of the corporation is computed. See section 43.

(c) *Records.* Every corporation claiming an allowance for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such allowance is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (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.

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(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.

§ 29.27 (c)-1 *Dividend carry-over.* The dividend carry-over to a given taxable year is computed as follows:

(a) If the basic surtax credit for the 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.

(b) 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.

(c) 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.

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.

Every corporation claiming a dividend carry-over for any taxable year shall file with its return for such year a concise statement setting forth the amount of the dividend carry-over claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carry-over claimed.

The computation of the dividend carry-over may be illustrated by the following examples:

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has subchapter A net income of $150,000 and a basic surtax credit of $225,000 for 1939. For 1940 its subchapter A net income is $200,000 and its basic surtax credit is $350,000, and for 1941 its subchapter A net income and its basic surtax credit are each $175,000. Its dividend carry-over to 1942 is $150,000, computed as follows:

(1) Basic surtax credit for 1940	$350,000
(2) Less subchapter A net income for 1940	200,000
(3) Dividend carry-over to 1942 ((1) minus (2))	150,000

Since the basic surtax credit for 1941 exactly equals the subchapter A net income for that year, neither that year nor the year 1939 need be taken into account. The preceding taxable year (1941) 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 (1939) over the subchapter A net income for such year. The third preceding taxable year (1939) is taken into account only if the subchapter A net income for the first preceding taxable year (1941) 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 (1940).

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 1939. For 1940 its subchapter A net income is $50,000 and its basic surtax credit is $75,000; and for 1941 its subchapter A net income and its basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1942 is $100,000, computed as follows:

Year 1940		
(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 1941		
(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 1942 (sum of (3) and (6))		100,000

For the reason why the year 1939 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 1939. For 1940 its subchapter A net income is $60,000 and its basic surtax credit is $160,000, and for 1941 its subchapter A net income and its basic surtax credit are $120,000 and $25,000, respectively. Its dividend carry-over to 1942 is $65,000, computed as follows:

Year 1940		
(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 1941		
(4) Subchapter A net income	$120,000	
(5) Basic surtax credit	25,000	
Year 1939		
(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	
Sum of (5) and (8)	85,000	
(9) Excess of subchapter A net income for the first preceding taxable year (1941) over sum of items (5) and (8)		35,000
(10) Dividend carry-over to 1942 ((3) minus (9))		65,000

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(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.

§ 29.27 (d)-1 *Dividends in kind.* Section 27 (d) imposes limitations upon the extent to which dividends paid in assets (other than money) may be recognized for purposes of determining the amount of the allowance for dividends paid which may be included in the basic surtax credit. Irrespective of the form of the corporate resolution by which a dividend is declared, if the dividend is ultimately and actually paid by the corporation in any property other than money, constituting its corporate assets, the amount of the allowance for dividends paid to which the corporation is entitled with respect thereto cannot exceed the lesser of the two following amounts determined as of the time of payment;

(a) The adjusted basis of such property in the hands of the corporation as provided for in section 113; or

(b) The fair market value of such property.

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.

The application of section 27 (d) may be illustrated by the following example:

Example. The S Corporation, in 1934, purchased stock of the Y Corporation for $100,000. In 1942 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 1942 the corporation used such stock for the payment of a dividend. The allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1942 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 1942	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 1942 with respect to such stock.

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act, 1942.]

(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 of 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.

§ 29.27 (e)-1 *Dividends in obligations of the corporation.* Section 27 (e) is concerned solely with the amount of the allowance for dividends paid for purposes of inclusion in the basic surtax credit to the extent that dividends are paid by a corporation in its own obligations. If the corporation ultimately pays a dividend in its own obligations (regardless of the form of the corporate resolution by which the dividend is declared), the amount of the allowance for dividends paid to which it is entitled with respect thereto for the year in which such dividend is paid is limted 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 allowance regardless of the identity of the holders of the obligations at the time of their redemption.

The term "obligations" as used in this section means any legal liability on the part of the corporation (not including liability as a guarantor, indorser, or

surety), regardless of when incurred, to pay a fixed or determinable sum of money, evidenced in writing executed by the corporation. The terms "redeemed" as used in this section includes (1) repurchase in the open market for investment or sinking fund purposes, (2) retirement, or (3) cancellation of the obligations before, at, or after maturity.

The application of section 27 (e) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, declared a dividend of $85,000 in 1936, payable in that year in its 5 percent bonds at 85. Pursuant to such declaration, bonds having an aggregate face value of $100,000 were issued during 1936 in payment of the dividend. The fair market value of the bonds at the time of issuance was $75,000. The dividends paid credit for 1936 was the fair market value of the bonds at the time of the dividend payment ($75,000), since such fair market value was lower than the face value ($100,000) of the obligations.

The bonds were redeemed in 1942. The corporation prior to the redemption of the bonds at face value deducted in its returns over the life of the bonds the $15,000 bond discount resulting from the payment in 1936 of the $85,000 dividend in bonds having a face value of $100,000. The allowance for dividends paid for purposes of computing the basic surtax credit with respect to the bond redemption for the taxable year 1942, in which the redemption of the bonds occurs, is $10,000, computed as follows:

Redemption price of bonds	$100,000
Less fair market value of bonds when dividend was paid in 1936	75,000
Difference	25,000
Less bond discount allowed as a deduction in computing net income	15,000
Amount treated as dividend paid in 1942	10,000

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(f) *Taxable stock dividends.* In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the amount with respect thereto which shall be used in computing the basic surtax credit shall be the fair market value of the stock or the stock right at the time of the payment.

§ 29.27 (f)-1 *Taxable stock dividends.* The allowance for dividends paid provided by section 27 (b) (1) is limited by section 27 (f), in the case of distributions in stock dividends or stock rights, to distributions which are taxable dividends in the hands of shareholders under section 115 (f). Such allowance, however, is limited in amount to the fair market value of such stock or stock rights at the time of the payment of the dividend. As to a distribution by a corporation or its own capital stock held as an investment, see § 29.27 (d)-1.

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act. 1942.]

(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.

§ 29.27 (g)-1 *Dividends paid credit for distributions in liquidation*—(a) *Distributions which diminish earnings or profits.* To the general rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27 (g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the 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:

(1) Under the provisions of section 115 (c), the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized.

In such a case, an allowance for dividends paid may be included in the basic surtax credit for the amount actually involved in such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the 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.* 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 purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example. The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000, and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1942, 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, 1942, 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.* 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 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 pur-

poses of the allowance for dividends paid, any such distribution so allocated shall be treated as a dividend paid only in the computation of the basic surtax credit allowable to the transferor, and must be consistently so treated by both corporations for the current and succeeding taxable years. Each corporation shall file as a part of its return for the taxable year involved (1) a statement setting forth concisely all of the material facts, including the date and the character of the transaction under section 112, the status at that time of the earnings or profits of both corporations, the date and amount of all dividend distributions subsequently made, and the particular distribution or portion thereof designated as effecting a distribution of the earnings or profits of the transferor corporation; and (2) a certified copy of the resolution of the board of directors of the transferee corporation with respect to the distribution. No allowance for dividends paid based upon such apportionment and allocation will be permitted unless the Commissioner is satisfied that the transferor corporation is entitled thereto pursuant to the provisions of this paragraph and that there has been a full compliance with the requirements of this paragraph. The provisions of this paragraph may be illustrated by the following example:

Example. The P Corporation, which makes its income tax returns on the basis of a fiscal year ending March 31, owned all of the capital stock of the S Corporation. The S Corporation, which makes its returns on the calendar year basis, was completely liquidated on December 1, 1942. 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 1942 of $20,000, and an adjusted net income of $45,000. It had paid no dividends prior to its liquidation. The P Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $60,000 in addition to earnings or profits of the taxable year computed as of the end of the year in the amount of $80,000, and an adjusted net income in the amount of $60,000. The P Corporation pays dividends as follows: June 15, 1942, $25,000; September 15, 1942, $25,000; December 15, 1942, $25,000; and March 15, 1943, $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, 1943, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation's accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(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.

§ 29.27 (h)-1 *Preferential distributions.* Section 27 (h) imposes a limitation upon the general rule that 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. The term "distribution," as used in this section, includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (g).

The application of the provisions of section 27 (h), relating to distributions which are preferrential, 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, 1942, declared a dividend of $5 a share payable in cash on August 1, 1942, to A. On September 15, 1942, it declared a dividend of $5 a share payable in cash on October 1, 1942, to B, C, and D. No allowance for dividends paid for the taxable year 1942 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1942, and October 1, 1942.

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 1942, 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, 1942, the corporation distributes a dividend of $125, $50 to E and $75 to F. The corporation is entitled to no allowance for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 in its basic surtax credit as a dividend paid.

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT—as amended by sec. 222 (a), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; sec. 132 (b) (c), Rev. Act 1942.]

(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.

§ 29.27 (i)-1 *Nontaxable distributions.* No allowance for dividends paid is permitted with respect to any part of the distribution by a corporation to its shareholders which is:

(a) Not out of earnings or profits of the taxable year or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (see section 115), or, in the case of distributions in liquidation, not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under § 29.27 (g)-1;

(b) In the case of a corporation which was classified as a personal service corporation under the Revenue Act of 1918 or the Revenue Act of 1921, out of earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921 (see section 115 (e)); or

(c) A distribution in stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and §§ 29.115-3 and 29.115-4).

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 divi-

dend as a result of the distribution. (See also section 27 (g).)

The application of section 27 (i) may be illustrated by the following examples:

Example (1). A, B, C, and D are the shareholders of the Y Corporation, which makes its income tax returns on the calendar year basis, D being an educational corporation exempt from income tax under section 101. On July 15, 1943, the Y Corporation paid a dividend (within the meaning of section 115) in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

Example (2). If the facts in the preceding example are the same, except that A and B make their returns on the basis of the fiscal year ending July 31, the Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

SEC. 28. CONSENT DIVIDENDS CREDIT [as amended by sec. 186 (e), Rev. Act 1942].

(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 of 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.

§ 29.28 (a) (1)-1 *Consent stock.* The term "consent stock," as defined in section 28 (a) (1), includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited. The application of section 28 (a) (1) may be illustrated as follows:

If in the case of 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.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

[(a) *Definitions.* As used in this section—]

(2) *Preferred dividends.* The term "preferred dividends" means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings or profits may be made within the taxable year.

§ 29.28 (a) (2)-1 *Preferred dividends.* The term "preferred dividends," as defined in section 28 (a) (2), includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution (other than in liquidation) of which on any class of stock is a condition precedent to a further distribution (other than in liquidation) of earnings or profits. A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some other class or classes of stock than the one on which it is payable. The application of section 28 (a) (2) may be illustrated as follows:

If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

[(a) *Definitions.* As used in this section—]

(3) *Consent dividends day.* The term "consent dividends day" means the last day of the taxable year of the corporation, unless during the last month of such year there have occurred one or more days on which was payable a partial distribution (as defined in paragraph (5)), in which case it means the last of such days.

§ 29.28 (a) (3)-1 *Consent dividends day.* The term "consent dividends day" is defined in section 28 (a) (3). If there was no partial distribution (as defined in section 28 (a) (5)) payable during the last month of the corporation's taxable year, the consent dividends day is the last day of such taxable year. If there were one or more days during such last month on which was payable a partial distribution, the consent dividends day is the last of such days. The day upon which shareholders, under the terms of the resolution of the board of directors directing the distribution, are entitled to receive the distribution is the day it is payable.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

[(a) *Definitions.* As used in this section—]

(4) *Consent distribution.* The term "consent distribution" means the distribution which would have been made if on the consent dividends day (as defined in paragraph (3)) there had actually been distributed in cash and received by each shareholder making a consent filed by the corporation under subsection (d), the specific amount stated in such consent.

§ 29.28 (a) (4)-1 *Consent distribution.* The term "consent distribution," as defined in section 28 (a) (4), does not include any actual distributions but is limited to the hypothetical distribution evidenced by shareholders' consents. The consent distribution equals the aggregate of all the amounts specified in the several consents, whether or not, if actually distributed, such amounts would have constituted in whole or in part a return of capital. Section 28 (a) (4) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, consisting of 500 shares, 200 of which are owned by A, and 300 by B. On December 15, 1942, the corporation distributes to A $5 per share, or $1,000. On December 31, 1942, B executes a consent to include $1,500 in his gross income as a taxable dividend. At the beginning of 1942 the corporation had no accumulated earnings or profits. For the taxable year 1942 the earnings or profits are $2,000. Nevertheless the corporation will be deemed to have made a consent distribution of $1,500 on December 15.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

[(a) *Definitions.* As used in this section—]

(5) *Partial distribution.* The term "partial distribution" means such part of an actual distribution, payable during the last month of the taxable year of the corporation, as constitutes a distribution on the whole or any part of the consent stock (as defined in paragraph (1)), which part of the distribution, if considered by itself and not in connection with a consent distribution (as defined in paragraph (4)), would be a preferential distribution, as defined in paragraph (6).

§ 29.28 (a) (5)-1 *Partial distribution.* The term "partial distribution," as defined in section 28 (a) (5), does not include preferred dividends even though payable on consent stock. The application of section 28 (a) (5) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, class A and class B, each of which is consent stock. Class A, consisting of 500 shares, is entitled to a preference of $3 per share, after which class B, consisting of 500 shares, is to receive $3 per share, whereupon class A and class B are entitled to share equally in any further distributions of earnings or profits. On December 15, 1942, the X Corporation distributes $6 per share or $3,000 on class A stock, and $3 per share or $1,500 on class B stock. Such distribution,

to the extent of $1,500 paid on class A stock, is a partial distribution.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

[(a) *Definitions.* As used in this section—]

(6) *Preferential distribution.* The term "preferential distribution" means a distribution which is not pro rata, or which is with preference to any share of stock as compared with other shares of the same class, or to any class of consent stock as compared with any other class of consent stock.

§ 29.28 (a) (6)-1 *Preferential distribution.* A preferential distribution is an actual distribution (other than the distribution of a preferred dividend as defined in section 28 (a) (2)), or a consent distribution, or a combination of the two, upon consent stock, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of consent stock as compared with any other class of consent stock. Such a preference exists if there is distributed to any shareholder (in proportion to the number of shares held by him) more or less than his pro rata part of a distribution as compared with the distribution made to any other shareholder of the same class, or if there is distributed to all the shareholders of one class of consent stock in the aggregate more or less than their pro rata part of a distribution as compared with the distribution made to all the shareholders of any other class of consent stock. If such preference exists, the entire distribution is preferential.

Section 28 (a) (6) may be illustrated by the following examples:

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1942, 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, 1942, there is distributed on the class A stock $2 per share, or $1,000, and on the class B stock $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the distribution.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (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 § 29.27 (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.

§ 29.28 (b)-2 *Liquidation of consent stock.* A corporation is not entitled to a consent dividends credit for any taxable year in which it has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1942, 1,000 shares of class A stock, the dividend rights of which are limited to an annual return of $6 per share. It also has outstanding on that date 1,000 shares of class B stock, which is entitled to receive the entire amount of any distribution made of earnings or profits within the taxable year after the payment on class A of $6 per share. On April 1, 1942, the corporation makes a distribution in partial liquidation, whereby five shares of class B stock (consent stock) are canceled or redeemed. The corporation is barred from obtaining a consent dividends credit for the taxable year, regardless of compliance with other requirements of section 28. If, however, class A stock (not consent stock), instead of class B stock, had been canceled or redeemed in the liquidation, the corporation would not be barred, because of such liquidation, from obtaining a consent dividends credit.

The mere purchase by a corporation of its own stock for investment is not, within the meaning of section 28 (b) (2), the taking of any step in, or in pursuance of a plan of, complete or partial liquidation and will not prevent a corporation from obtaining a consent dividends credit for the taxable year.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (c)-1 *Amount of consent dividends credit.* The consent dividends credit forms part of the basic surtax credit (see section 27 (b) (1)). It consists of the amount which the corporation woud be permitted to include in its basic surtax credit as a dividend paid if it had distributed to each shareholder whose consent has been filed pursuant to section 28 (d), and each such shareholder had received, on the consent dividends day (see section 28 (a) (3)), an amount equal to the amount specified in such consent. The amount of the consent dividends credit, therefore, cannot exceed the sum of the amounts specified in the several consents. It may, however, regardless of the fact that such amounts are treated and taxed in their entirety to the consenting shareholders as a dividend (see section 28 (f)), be smaller than the sum of the specified amounts, because it is limited to the amount which would have been allowed as dividends paid if an actual distribution had been made.

The provisions of section 28 (c) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year. Its earnings and profits for the calendar year 1942 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, 1942. The sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actualy been distributed by the X Corporation on December 31, 1942, only $8,000 would have constituted a dividend. The allowance for dividends paid, includible in the computation of the basic surtax credit, would have amounted to only $8,000. The consent dividends credit of the corporation, therefore, is limited to $8,000.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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 the 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 shareholders, on the last day of the taxable year, of the corporation, of any class of consent stock; and

(2) Unless in each such consent the shareholders 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 con-

sent 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.

§ 29.28 (d)-1 *Making and filing of consents.* A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with these regulations and the instructions on the form or issued therewith and may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, i. e., the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. In the consent such person must agree:

(a) 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

(b) If he is a shareholder who is taxable with respect to a dividend only if received from sources within the United States, that the specific amount stated in his consent shall be considered as a dividend received by him from sources within the United States.

A consent may be made at any time not later than the due date of the corporation's income tax return for the taxable year for which the credit is claimed (see § 29.53-4) or such consent may be made at any time not later than one year after October 21, 1942, if the corporation was a personal holding company for the taxable year for which the credit is claimed. With such return, and not later than the due date thereof, or in the case of a personal holding company referred to in section 28 (d) (1), within one year after October 21, 1942, the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973, or Form 973A, in the case of a personal holding company, showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distribution made during the taxable year to shareholders, and giving all the other information required by the form.

In the event that any consent filed by the corporation is made by a shareholder in the payment to whom of a dividend in cash, on the last day of the taxable year of the corporation, the corporation would have been required to deduct and withhold any amount as a tax under section 143 (b) or 144, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(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.

§ 29.28 (d)-2 *Consent distribution must be nonpreferential.* The application of section 28 (d) (3) may be illustrated as follows:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1942, the corporation distributes $600 to B and $100 to A. On December 31, 1942, 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.

§ 29.28 (d)-3 *Overpayments and deficiencies.* For the refund or credit of any overpayment, and the assessment or collection of any deficiency referred to in section 186 (h) of the Revenue Act of 1942, see § 29.504-6.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (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). See § 29.27 (h)-1.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (f)-1 *Taxability of amounts specified in consents.* Once a shareholder's consent is filed, the full amount specified therein shall be included in his gross income as a taxable dividend, and, in cases where the shareholder is taxable on a dividend only if received from sources within the United States, shall be treated as a dividend so received; regardless of:

(a) Whether he actually so includes it in his return;

(b) 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

(c) Whether the corporation, as a result of filing such consents, is entitled to any consent dividends credit or to a smaller consent dividends credit than the sum of the amounts specified in the several consents.

The ground upon which a consent dividends credit is denied the corporation does not affect the taxability to a shareholder whose consent has been filed of the amount specified in his consent. Thus, he is taxable on the full amount so specified, though the corporation receives no credit or a smaller credit than the sum of the amounts specified in the consents because the corporation has no earnings and profits or a smaller amount of earnings and profits than the sum of the amounts specified in the consents. The full amount specified in a shareholder's consent which has been filed is also taxable to him as a dividend though a consent dividends credit is denied the corporation because (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 § 29.28 (d)-1.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (g)-1 *Treatment of amount specified in consent of corporate shareholder.* From the standpoint of computing a shareholder's income for a taxable year relative to which he has agreed to include a specific amount in gross income, such amount is treated exactly as though such shareholder had received in cash a taxable dividend equal to the amount specified in his consent. Therefore, in the case of a corporate shareholder, such amount shall be included in the computation of its earnings and profits for the taxable year and its accumulated earnings and profits as of the close of the taxable year. The effect of a corporate shareholder's consent upon the computation of its earnings and profits may be illustrated as follows:

Example. The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1942 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1942 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 1942 with $5,000 accumulated earnings and profits, to have made no distributions during the year, and (without considering the amount specified in its consent) to have had neither profit nor loss during the year. Its earnings and profits for the year will be $10,000 and its accumulated earnings and profits at the close of the year will be $15,000.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(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.

§ 29.28 (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 1942. 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 1942, 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:

(1) In the case of the X Corporation—

(*a*) Its consent dividends credit is $40, being 80 percent of the amount specified in A's consent;

(*b*) Its basic surtax credit, assuming it has no net operating loss in the preceding year and no bank affiliate credit, is $80, composed of a consent dividends credit of $40 and an allowance for dividends paid of $40;

(*c*) The amount of its accumulated earnings and profits as of the close of the taxable year is zero, because of the transfer of $40 (the amount of the consent dividends credit) from earnings and profits to capital account and the deduction of an additional $40 on account of dividends paid to B. If, therefore, in the following year the X Corporation has no earnings and profits but nevertheless makes a distribution to shareholders, no part of such distribution will be a dividend, but it will all constitute a return of capital.

(2) In the case of A—

(*a*) A is taxable on $50 as a dividend;

(*b*) The basis of his stock is increased by $40, his pro rata share, i. e., all, of the consent dividends credit.

(3) In the case of B—

(*a*) B is taxable on $40 as a dividend;

(*b*) The basis of his stock is reduced by $10.

[SEC. 28. CONSENT DIVIDENDS CREDIT—as amended by sec. 186 (e), Rev. Act 1942.]

(j) *Amounts not included in shareholders' 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

SEC. 31. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax, to the extent provided in section 131.

SEC. 32. TAXES WITHHELD AT SOURCE.

The amount of tax withheld at the source under section 143 or 144 shall be allowed as a credit against the tax.

SEC. 33. CREDIT FOR OVERPAYMENTS.

For credit against the tax of overpayments of taxes imposed by this chapter for other taxable years, see section 322.

SEC. 34. CREDITS AGAINST VICTORY TAX [as added by sec. 172 (f), Rev. Act 1942, and amended by sec. 2 (b), Current Tax Payment Act 1943].

For credits against victory tax, see sections 453 and 454. [NOTE: Prior to its amendment by sec. 2 (b), Current Tax Payment Act 1943, such amendment being effective July 1, 1943, section 34 reads as follows: "For credits against victory tax, see sections 453, 454, and 466 (e)."]

SEC. 35. CREDIT FOR TAX WITHHELD ON WAGES [as added by sec. 172 (f), Rev. Act 1942, and amended by sec. 3, Current Tax Payment Act 1943].

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 such amount shall be allowed as a credit against the tax for the last taxable year so beginning. [NOTE. Prior to its amendment by sec. 3, Current Tax Payment Act 1943, section 35 read as follows: "For credits against the tax withheld on wages, see section 466 (e)."]

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22 (c).

§ 29.41-1 *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' 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 §§ 29.42-1 to 29.42-3, 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.

§ 29.41-2 *Bases of computation and changes in accounting methods.* Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see

sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 29.42-2 and 29.42-3.) 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 § 29.22 (c)-5.)

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.

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 §§ 29.22 (c)-1 to 29.22 (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 § 29.42-4); 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 §§ 29.22 (a)-7 and 29.23 (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 regulations thereunder with respect to changing to optional method of inventorying goods.

Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in § 29.44-1, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In case 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.

§ 29.41-3. *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 § 29.54-1.) 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 §§ 29.22 (c)-1 to 29.22 (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.

§ 29.41-4 *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 § 29.46-1.

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED [as amended by secs. 114, 115 (a), Rev. Act 1941; sec. 134 (a), Rev. Act. 1942].

(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. [For application of this subsection to taxable years beginning before January 1, 1943, see § 29.42-1 (b).]

(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, 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 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.

§ 29.42-1 *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 §§ 29.41-1 to 29.41-3, inclusive.) (As

to income from noninterest-bearing obligations issued at discount, see § 29.42-6, and as to income from short-term obligations issued on a discount basis, see § 29.42-7.) 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 § 29.23 (k)-1.) Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

(b) *Last taxable year of decedent.* If the taxable year in which falls the date of the death of a taxpayer began on or after January 1, 1943, then there shall be included in computing net income for such year 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 § 29.44-5. This amount must be included in computing net income regardless of the method of accounting followed by the taxpayer.

Section 134 (a) of the Revenue Act of 1942 changed the last sentence of section 42 (a) of the Internal Revenue Code to its present form, as set forth above. Prior to such change, the last sentence of section 42 (a) provided as follows:

> In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

Section 134 (f) of the Revenue Act of 1942 provides that the change in the last sentence of section 42 (a) shall be applicable to taxable years beginning after December 31, 1942. Section 134 (g) of the Revenue Act of 1942 provides that such change shall be applicable to taxable years beginning before January 1, 1943, if the executor, the administrator, or other personal representative of the taxpayer and the persons who acquire as beneficiaries of his estate or by reason of his death his right to receive any income make the election provided in such section 134 (g) (see § 29.126-4) to have the amendments made by section 134 apply to the law in effect for such taxable years. Accordingly, if the taxable year in which falls the date of the death of a taxpayer begins before January 1, 1943, the provisions of the first paragraph of this paragraph (b) are applicable only if such election has been made. See § 29.126-4, relating to such election and to the method of computing, and limitations with respect to, credit or refund of any overpayment which is a result of such election. If such election is not made, then there shall be included in computing net income for such taxable year, in addition to the amounts described in paragraph (a) of this section, all amounts accrued up to the date of the taxpayer's death which are not otherwise properly includible in respect of such taxable year or a prior taxable year, regardless of the fact that the decedent may have kept his books and made his return on the basis of cash receipts and disbursements.

§ 29.42-2 *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.

§ 29.42-3 *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.

§ 29.42-4 *Long-term contracts.* Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this 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:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in § 29.41-2.

§ 29.42-5 *Subtraction for redemption of trading stamps.* If a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing:

(a) The total issue of stamps during each year;

(b) The total stamps redeemed in each year; and

(c) The rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year, regardless of the year when such redeemed stamps were issued.

A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

§ 29.42-6 *Noninterest bearing obligations issued at discount.* 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.

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 1945, a taxpayer who makes his income tax returns on the calendar year basis and computes his net income on the cash receipts and disbursements basis holds the following United States bonds:

(a) United States savings bonds having a maturity value of $10,000, which he purchased on January 1, 1938, for $7,500. The entire increase in the redemption price of these bonds is exempt from normal tax but only such part of the increase as is attributable to $5,000 in principal amount (purchase price) of such bonds is exempt from the surtax.

(b) United States Defense savings bonds, Series E, having a maturity value of $5,000, which he purchased on January 1, 1942, for $3,750. The increase in the redemption price of these bonds is subject to both the normal tax and the surtax.

(c) United States savings bonds, Defense Series F, having a maturity value of $10,000, which he purchased on January 1, 1944, for $7,400. The increase in the redemption price of these bonds is subject to both the normal tax and the surtax.

The taxpayer holds no other obligations of the type described in this section. In his return for 1945 the taxpayer elects to treat the increases in the redemption prices of such bonds occurring in such year as income to him for such year. Under this section he is required in such return to report with respect to such bonds $250 as subject to normal tax and $750 as subject to surtax, determined as follows:

	Subject to normal tax		Subject to surtax	
	Increases prior to 1945	Increases in 1945	Increases prior to 1945	Increases in 1945
Bonds acquired Jan. 1, 1938	None	None	$400	$100
Bonds acquired Jan. 1, 1942	$100	$100	100	100
Bonds acquired Jan. 1, 1944	None	50	None	50
Total	$250		$750	

In the case of the United States savings bonds acquired on January 1, 1938, the increases of $400 and $100 in the redemption price are attributable to the principal amount (purchase price) in excess of $5,000.

§ 29.42-7 *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 issued on or after March 1, 1941, 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 issued on or after March 1, 1941, 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 § 29.117-1.

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN [as amended by sec. 134 (b), Rev. Act 1942].

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. [NOTE. For application of this section to taxable years beginning before January 1, 1943, see § 20.43-1 (b).]

§ 29.43-1 *"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.

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 § 29.131-6 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.

(b) The provisions of paragraph (a) are in general applicable with respect to the taxable year during which the taxpayer dies if such taxable year begins on or after January 1, 1943. However, if the taxpayers 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.

Section 134 (b) of the Revenue Act of 1942 changed the last sentence of section 43 of the Internal Revenue Code to its present form, as set forth above. Prior to such change, the last sentence of section 43 read as follows:

In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death (except deductions under section 23 (o) if not otherwise properly allowable in respect of such period or a prior period.

Section 134 (f) of the Revenue Act of 1942 provides that the change in the last sentence of section 43 shall be applicable to taxable years beginning after December 31, 1942. Section 134 (g) of the Revenue Act of 1942 provides that such change shall be applicable to taxable years beginning before January 1, 1943, if the executor, the administrator, or other personal representative of the taxpayer and the persons who acquire as beneficiaries of his estate or by reason of his death his right to receive any income make the election provided in such section 134 (g) (see § 29.126-4) to have the amendments made by section 134 apply to the law in effect for such taxable years. Accordingly, if the taxable year in which falls the date of the death of a taxpayer begins before January 1, 1943, the provisions of the first paragraph of this paragraph are applicable only if such election has been made. See § 29.126-4, relating to such election and to the method of computing, and limitations with respect to, credit or refund of any overpayment which is a result of such election. If such election is not made, then there shall also be allowed as deductions and credits for such taxable year, in addition to the amounts described in paragraph (a) of this section, all amounts (except deductions under section 23 (o)) accrued up to the date of the taxpayer's death which are not otherwise allowable with respect to such taxable year or a prior taxable year, regardless of the fact that the decedent may have been required to keep his books and make his return on the basis of cash receipts and disbursements.

§ 29.43-2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in personal property.* Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personality.*[1] 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.

[1] So in original.

(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.

§ 29.44-1 *Sale of personal property on installment plan.* Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the installment plan. Dealers who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default:

(a) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(b) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(c) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(d) By conveyance to a trustee pending performance of the contract and subject to its provisions.

The general purpose and effect being the same in all of these cases, the same rule is uniformly applicable. The general rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for, bears to the total contract price. Thus, the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment basis of returning income. But in the case of any taxpayer who, by an original return made prior to February 26, 1926, changed the method of reporting his net income for the taxable year 1924 or any prior taxable year to the installment basis, see section 705 of the Revenue Act of 1928. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued," as provided by sections 43 and 48. A dealer who desires to compute his income on the installment basis shall maintain books of 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.

The income from a casual sale or other casual disposition of personal property (other than property of a kind which should properly be included in inventory) may be reported on the installment basis only if (1) the sale price exceeds $1,000 and (2) the initial payments do not exceed 30 percent of the selling price.

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also § 29.44-5.) 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 § 29.23 (k)-1.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The property repossessed shall be carried on the books of the vendor at its fair market value at the time of repossession.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursement basis, such a course is permissible.

§ 29.44-2 *Sale of real property involving deferred payments.* Under section 44 deferred-payment sales of real property include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (b) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments. Such sales, either under (a) or (b), fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in §§ 29.44-1 and 29.44-3, 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.

§ 29.44–3 *Sale of real property on installment plan.* In transactions included in class (1) in § 29.44–2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If the purchaser defaults in any of his payments, and the vendor returning income on the installment basis reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. (See also § 29.44–5.) 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 § 29.23 (k)–1). If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

§ 29.44–4 *Deferred-payment sale of real property not on installment plan.* In transactions included in class (2) in § 29.44–2, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

If the vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (a) 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 (b) 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, obsolescense, 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 ascertained to be worthless and charged off within the taxable year, 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 § 29.23 (k)–3 with respect to property reacquired in a foreclosure proceeding.

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.

§ 29.44–5 *Gain or loss upon disposition of installment obligations.* The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the 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.

The application of section 44 (d) may be illustrated by the following examples:

Example (1). In 1940 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1918 at a cost of $10,000. During 1940 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 1942, 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 1942 is $5,500, computed as follows:

Proceeds of sales 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 1942		5,500

Example (2). Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1942 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 1942 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 1942	6,500

If the taxpayer, referred to in the above examples (1) and (2) as Corporation M, had been an individual, the taxable income to be reported, shown above as $5,500 and $6,500, respectively, would have been limited to 50 percent thereof by section 117 (b), the real estate having been held for more than 24 months prior to its sale in 1940. See also section 117 (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.

See section 117 as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

§ 9.45-1 *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 these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, 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.

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.

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

SEC. 46. CHANGE OF ACCOUNTING PERIOD.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 47.

§ 29.46-1 *Change of accounting period.* If a taxpayer (other than a subsidiary corporation required to change its accounting period by reason of the provisions of § 23.14 or § 33.14 of this chapter) changes his accounting period he shall, prior to the expiration of 30 days from the close of the fractional part of the year for which a return would be required to effect the change, furnish to the collector, for transmission to the Commissioner, the information required on Form 1128. However, if the fractional

part of the year for which a return would be required to effect the change ends after July 31, 1943, such taxpayer shall, before using the new period for income tax purposes, secure the consent of the Commissioner; and application for permission to change the accounting period shall be made 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 a change of accounting period of a subsidiary is required for income tax purposes under § 23.14 of this chapter or for excess profits tax purposes under § 33.14 of this chapter, the information required on Form 1128 shall be furnished by the subsidiary at or before the time of filing the consolidated income tax return or the consolidated excess profits tax return, as the case may be. For the due date of returns for fractional parts of a year see § 29.53-1. If the change is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. (See section 47.)

SEC. 47. RETURNS FOR A PERIOD OF LESS THAN TWELVE MONTHS [as amended by sec. 135 (a) (c), Rev. Act 1942].

(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.* The Commissioner with the approval of the Secretary shall by regulations prescribe the method of applying the provisions of subsections (b) and (c) (relating to computing income on the basis of a short period, and placing such income on an annual basis) to cases where the taxpayer makes a separate return under subsection (a) on account of a change in the accounting period, and it appears that for the period for which the return is so made he has received earned income.

(e) *Reduction of credits against net income.* In the case of a return made for a fractional part of a year, except a return made under subsection (a), on account of a change in the accounting period, the personal exemption and credit for dependents shall be reduced respectively to amounts which bear the same ratio to the full credits provided as the number of months in the period for which the 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.

§ 29.47-1 *Returns for periods of less than 12 months.* No return can be made for a period of more than 12 months. A separate return for a fractional part of a year is therefore required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns in the several cases are stated in section 47 (a). The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time, except as otherwise provided in § 29.53-1 and § 29.56-1 (a). (See sections 53 and 56.) If a return is made for a fractional part of a year, except where a return is made for a period of less than 12 months by reason of a change in accounting period, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in the period for which the return is made bears to 12 months. 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 the personal exemption for such taxable year as so reduced. In the case of a return by a corporation for a fractional part of a year, the credit provided by section 26 (e) for the income of the corporation subject to excess profits tax is considered an amount of which the excess profits tax of the corporation for such period is 90 percent. For the computation of such credit in case the net income of the corporation is placed on an annual basis, see § 29.47-2.

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.

§ 29.47-2 *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.* 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.

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. If the corporation computes its excess profits tax under section 711 (a) (3) (A), the credit provided in section 26 (e) for the adjusted excess profits net income of the corporation is determined with the excess profits net income placed on an annual basis under such section 711 (a) (3) (A). The credit for the adjusted excess profits net income so determined on an annual basis is applied against the net income after such net income has been placed on an annual basis. If the corporation computes its excess profits tax under section 711 (a) (3) (B), the credit provided in section 26 (e) is computed as an amount of which the tax of the corporation for the short period under section 711 (a) (3)

(B) is 90 percent. This adjusted excess profits net income is placed on an annual basis by multiplying by 12 and dividing by the number of months in the short period, and the credit for the adjusted excess profits net income so determined on an annual basis is applied against the net income after such net income has been placed on an annual basis.

The following examples illustrate the application of this paragraph:

Example (*1*). A citizen of the United States made a return for a 10-month period ended October 31, 1942, on account of a change in accounting period. His net income including his earned net income for such 10-month period was $10,000 and his earned net income for such period was $4,000. He was entitled to a personal exemption of $1,200 but not to a credit for dependents. His tax for the period is $2,412.67, computed as follows:

Net income for 10-month period		$10,000.00
Multiplied by 12		120,000.00
Net income on annual basis ($120,000÷10)		12,000.00
Less: Personal exemption		1,200.00
Surtax net income		10,800.00
Earned net income for 10-month period	$4,000.00	
Multiplied by 12	48,000.00	
Earned net income on annual basis ($48,000÷10)	4,800.00	
Subtracting: Earned income credit (10 percent of $4,800)		480.00
Net income subject to normal tax		10,320.00
Normal tax (6 percent of $10,320)		619.20
Surtax on $10,800		2,276.00
Total tax on annual basis		2,895.20
Amount of tax for period ($2,895.20×10/12)		2,412.67

Example (*2*). The X Corporation made a return for the 8-month period ended August 31, 1942, 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 adjusted excess profits net income of the corporation for such period was $27,375, computed after the excess profits net income for such period was placed on an annual basis under section 711 (a) (3) (A), and its excess profits tax computed under such section was $16,402.50 $\left(\frac{243}{365}\times 90\right.$ percent of $\left.\$27{,}375\right)$. The tax for the 8-month period is $16,460, computed as follows:

Net income for 8-month period		$72,000
Multiplied by 12		864,000
Net income on annual basis ($864,000÷8)		108,000
Less: Adujusted excess profits net income		27,375
Remainder		80,625
Dividends received, subject to the credit provided in section 26 (b)	$12,000	
Multiplied by 12	144,000	
Dividends received placed on annual basis ($144,000÷8)	18,000	
Subtracting: Credit provided in section 26 (b) for dividends received (85 percent of $18,000)		15,300
Surtax net income		65,325
Interest on United States obligations subject to credit provided in section 26 (a)	$4,000	
Multiplied by 12	48,000	
Subtracting: Credit provided in section 26 (a) for interest placed on annual basis ($48,000÷8)		$6,000
Normal tax net income		59,325
Normal tax on $59,325		14,238
Surtax on $65,325		10,452
Total tax on annual basis		24,690
Amount of tax for period ($24,690×8/12)		16,460

If it had been assumed that the corporation had applied for the benefits of section 711 (a) (3) (B), and that the excess profits tax of the corporation was reduced under that section to $11,250, then in the above computations the credit for the adjusted excess profits net income of the corporation, applied against the $108,000 net income (as placed on an annual basis), would not be $27,375, the amount computed upon the application of section 711 (a) (3) (A), but would be $18,750, the adjusted excess profits net income computed on the basis of the excess profits tax determined under section 711 (a) (3) (B) and placed on an annual basis. The computation is as follows:

Excess profits tax for short period	$11,250
Adjusted excess profits net income for short period (amount of which excess profits tax is 90 percent, or $\frac{100}{90}\times\$11{,}250$)	12,500
Multiplied by 12	150,000
Adjusted excess profits net income on annual basis ($150,000÷8)	18,750

(b) *Tax for short period determined by annual income.* 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). 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.

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. In the case of a corporation, the credit provided by section 26 (e) for the adjusted excess profits net income of the corporation is computed as an amount of which the excess profits tax imposed for such 12-month period is 90 percent. The excess profits tax imposed for such 12-month period is the excess profits tax for the short period plus, for any taxable year which includes only part of such 12-month period, such part of the excess profits tax for such taxable year as is allocable to the part of the 12-month period included in such taxable year. The excess profits tax for such a taxable year may, in general, be allocated to the 12-month period in such proportion as the excess profits net income computed for the part of the 12-month period included in the taxable year is of the excess profits net income computed for the taxable year. However, if some other method of apportionment will more clearly reflect the portion of the excess profits tax which is attributable to the part of the 12-month period included in the taxable year, such other method shall be used.

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, 1942, to September 30, 1942, is the calendar year 1942. The 3-month period October 1, 1942, to December 31, 1942, is a part of the fiscal year ending September 30, 1943. 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,

1943, 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.

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. In computing the tax of a corporation for the short period without placing its net income on an annual basis, the adjusted excess profits net income of the corporation is, for the purpose of determining the credit under section 26 (e), an amount of which the excess profits tax of the corporation for the short period is 90 percent.

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) of this section. In the period from November 1, 1942, to December 31, 1942, the taxpayer has $1,000 net income, all of which is earned income. The net income for the 12-month period from January 1, 1942, to December 31, 1942, including the earned net income for such period, is, therefore, $11,000, of which $5,000 is earned income. The taxpayer files an application under the provisions of 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, 1942, to December 31, 1942. His tax is reduced to $2,292.73, computed as follows:

Net income for 12-month period January 1, 1942, to December 31, 1942		$11,000.00
Less: Personal exemption		1,200.00
Surtax net income		9,800.00
Less: Earned income credit (10 percent of $5,000)		500.00
Net income subject to normal tax		9,300.00
Normal tax (6 percent of $9,300)		558.00
Surtax on $9,800		1,964.00
Total tax on annual income		2,522.00
Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00	
Net income for 12-month period January 1, 1942, to December 31, 1942	11,000.00	
Amount of tax for 10-month period $\left(\frac{10,000}{11,000}\times \$2,522\right)$		2,292.73

The amount of tax that would be due if the income for the short period were not placed on an annual basis is $2,256, computed as follows:

Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00
Less: Personal exemption $\left(\frac{10}{12}\times \$1,200\right)$	1,000.00
Surtax net income	9,000.00
Less: Earned income credit (10 percent of $4,000)	400.00
Net income subject to normal tax	8,600.00
Normal tax (6 percent of $8,600)	516.00
Surtax on $9,000	1,740.00
Total tax for period	2,256.00

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 $2,292.73, is greater than the tax that would be due if the income for the short period were not placed on an annual basis, or $2,256, the tax for the short period is reduced to $2,292.73, 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 paragraph, except that during the period from November 1, 1942, to December 31, 1942, the taxpayer has no income, but has deductible business expenses of $1,000. His net income for the 12-month period from January 1, 1942, to December 31, 1942, including his earned net income, is, therefore, $9,000, of which $4,000 is earned income. The taxpayer files 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, 1942, to October 31, 1942, without placing such net income on an annual basis is $2,256 (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, 1942, to December 31, 1942, is $2,062.22, computed as follows:

Net income for 12-month period January 1, 1942, to December 31, 1942		$9,000.00
Less: Personal exemption		1,200.00
Surtax net income		7,800.00
Less: Earned income credit (10 percent of $4,000)		400.00
Net income subject to normal tax		7,400.00
Normal tax (6 percent of $7,400)		444.00
Surtax on $7,800		1,412.00
Total tax on annual income		1,856.00
Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00	
Net income for 12-month period January 1, 1942, to December 31, 1942	9,000.00	
Amount of tax for 10-month period $\left(\frac{10,000}{9,000}\times \$1,856\right)$		2,062.22

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 $2,256, is greater than $2,062.22, 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 $2,256.

Example (3). The facts are the same as in example (2) in paragraph (a) 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, 1942, to December 31, 1942, 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), and its excess profits net income computed for such 4-month period is $12,000. The net income for the 12-month period from January 1, 1942, to December 31, 1942, 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 excess profits tax for the short period is $16,402.50. The excess profits tax for the taxable year from September 1, 1942, to August 31, 1943, which includes the last four months of the 12-month period, is $43,200, and the excess profits net income for such period is $96,000. The tax for the short period is reduced under section 47 (c) (2) to $15,489.61, computed as follows:

January 1, 1942, to December 31, 1942		$88,000.00
Excess profits tax for 8-month period January 1, 1942, to August 31, 1942	$16,402.50	
Excess profits tax for fiscal year September 1, 1942, to August 31, 1943	43,200.00	
Excess profits net income for period September 1, 1942, to December 31, 1942	12,000.00	
Excess profits net income for fiscal year September 1, 1942, to August 31, 1943	96,000.00	
Portion of excess profits tax allocable to period September 1, 1942, to December 31, 1942 $\left(\frac{12,000}{96,000}\times \$43,200\right)$	5,400.00	
Excess profits tax imposed for 12-month period January 1, 1942, to December 31, 1942 ($16,402.50+$5,400.00)	21,802.50	
Subtracting: Adjusted excess profits net income for 12-month period January 1, 1942, to December 31, 1942 (amount of which tax for 12-month period is 90 percent, or $\left(\frac{100}{90}\times \$21,802.50\right)$)		24,225.00
Less: Dividends received credit provided by section 26 (b) (85 percent of $15,000)		12,750.00
Surtax net income		51,025.00
Less: Credit provided in section 26 (a) for interest on United States obligations		5,000.00
Normal tax net income		46,025.00
Normal tax on $46,025		10,767.75
Surtax on $51,025		8,164.00
Total tax on annual income		18,931.75
Net income for 8-month period January 1, 1942, to August 31, 1942	$72,000	
Net income for 12-month period January 1, 1942, to December 31, 1942	$88,000	
Amount of tax for 8-month period January 1, 1942, to August 31, 1942		

$\left(\frac{72,000}{88,000} \times \$18,931.75\right)$ ---------- $15,489.61

The amount of tax that would be due if the income for the short period were not placed on an annual basis is $15,354.75, computed as follows:

Net income for 8-month period		$72,000.00
Excess profits tax for 8-month period	$16,402.50	
Subtracting: Adjusted excess profits net income (amount of which tax for period is 90 percent, or $\left(\frac{100}{90} \times \$16,402.50\right)$)	18,225.00	
Credit for dividends received (85 percent of $12,000)	10,200.00	
		28,425.00
Surtax net income		43,575.00
Less: Credit for interest on United States obligations		4,000.00
Normal tax net income		39,575.00
Normal tax on $39,575		8,768.25
Surtax on $43,575		6,586.50
Total tax for period		15,354.75

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 $15,489.61, is greater than the tax that would be due if the income for the short period were not placed on an annual basis, or $15,354.75, the tax for the short period is reduced to $15,489.61, 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), 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, 1942, to September 30, 1942. 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, 1942, the twelfth month after the beginning of the short period. In this case, the taxpayer must file its application not later than December 15, 1943, the time prescribed for filing the return for its fiscal year ending September 30, 1943. 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.

SEC. 48. DEFINITIONS [as amended by sec. 135 (d), Rev. Act 1942].

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[1] "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.[1]

(d) *Trade or business.* The term "trade or business" includes the performance of the functions of a public office.

RETURNS AND PAYMENT OF TAX

SEC. 51. INDIVIDUAL RETURNS [as amended by sec. 7, Rev. Act 1940; sec. 112 (a), Rev. Act 1941; secs. 131 (c), 136 (a), Rev. Act 1942].

(a) *Requirement.* The following individuals shall each make a 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 his 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 the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual who is single or who is married but not living with husband or wife, if having a gross income for the taxable year of $500 or over.

(2) Every individual who is married and living with husband or wife, if no joint return is made under subsection (b) and if—

(A) Such individual has for the taxable year a gross income of $1,200 or over, and the other spouse has no gross income; or (B) Such individual and his spouse each has for the taxable year a gross income and the aggregate gross income is $1,200 or over.

(b) *Husband and wife.* In the case of a husband and wife living together the income of each (even though one has no gross income) may be included in a single return made by them jointly, in which case the tax shall be computed on the aggregate income, and the liability with respect to the tax shall be joint and several. No joint return may be made if either the husband or wife is a nonresident alien.

[1] This Part comprises sections 41 to 48, inclusive.

(c) *Persons under disability.* If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

(d) *Signature presumed correct.* The fact that an individual's name is signed to a filed return shall be prima facie evidence for all purposes that the return was actualy signed by him.

(e) *Fiduciaries.* For returns to be made by fiduciaries see section 142.

§ 29.51-1 *Individual returns*—(a) *In general.* For each taxable year a return of income shall be made by each citizen of the United States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, whether or not such citizen or resident is the head of a family or has dependents:

(1) If single or married but not living with husband or wife for any part of the taxable year, and if having for the taxable year a gross income (as defined in sections 22 and 116) of $500 or over, or such income is equal to, or in excess of, the credit allowed by section 25 (b) (1) and (3) (computed without regard to any credit to which he may be entitled as the head of a family). See §§ 29.25-7 and 29.47-1.

(2) If married and living with husband or wife for the entire taxable year, if no joint return is made, and if:

(i) Having for the taxable year a gross income of $1,200 or over, and the other spouse has no gross income; or

(ii) Such individual and his or her spouse each has for the taxable year a gross income and the aggregate gross income of the two is $1,200 or over; or

(iii) Such taxable year is a period of less than 12 months, if such individual has for the taxable year a gross income, and if the aggregate gross income of such individual and his or her spouse is equal to, or in excess of, the credit for personal exemption allowed by section 25 (b) (1) and (3). See §§ 29.25-7 and 29.47-1.

(3) If married and living with husband or wife for any part of the taxable year but not at the close thereof, or if married and living with husband or wife at the close of the taxable year, but not during the entire taxable year, if no joint return is made, and if:

(i) Having for the taxable year a gross income equal to, or in excess of, the credit allowed him or her by section 25 (b) (1) and (3) (computed without regard to any credit to which he or she may be entitled as the head of a family (see § 29.25-7), and the other spouse has no gross income; or

(ii) Such individual and his or her spouse each has for the taxable year a gross income, and their aggregate gross income is $1,200 or over, or is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to any credit to which either or both may be entitled as the head of a family (see § 29.25-7)).

(b) *Joint returns.* A husband and wife, if living together at the close of the taxable year, may elect to make a joint return (see section 51 (b)), that is, to include in a single return made by them jointly the income and deductions

of each, even though one has no gross income. In such a case, the tax shall be computed on the aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year. A joint return may not be made if either the husband or wife is a nonresident alien.

A joint return of a husband and wife (if not made by an agent, see § 29.51-2) shall be signed by both spouses. An oath is not necessary, but both spouses shall verify the return as provided in section 51. If signed by one spouse as agent for the other, authorization for such action must accompany the return. (See § 29.51-2.) The spouse acting as agent for the other shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

For returns by fiduciaries, see section 142; by partnerships, see section 187; and by nonresident alien individuals, see section 217. For time and place for filing returns, see section 53.

§ 29.51-2 *Form of return.* The return shall be on Form 1040 except that it may be on short Form 1040A if (1) the gross income does not exceed $3,000 and consists wholly of salary, wages, compensation for personal services, dividends, interest, or annuities, (2) the return is made on a cash basis, and (3) the taxpayer (if not excluded by section 404) elects to pay the tax imposed by section 400 in lieu of the tax imposed by sections 11 and 12. The forms may be had from the collectors of the several districts. The return may be made by an agent if, by reason of illness, the person liable for the making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the return. Whenever a return is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, 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 §§ 29.217-1 and 29.217-2.

The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided at the top of the return for the name and address of the taxpayer. A taxpayer having a permanent business address may give that address as the principal or mailing address, provided that the complete home or residential address is also given within the space provided.

§ 29.51-3 *Return of income of minor.* An individual, although a minor, who is single, is required to render a return of income if he has a gross income of his own of $500 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 which belong to him, is at least $500, 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 § 29.142-2.) If he is married, see § 29.51-1. If under the laws of a State the earnings of a minor belong to the minor, such earnings, regardless of amount, are not required to be included in the return of the parent. In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return.

§ 29.51-4 *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 under oath or affirmation. The oath or affirmation may be administered by any person duly authorized to administer oaths for general purposes by the law of the United States or of any State, Territory, or possession of the United States, or of the District of Columbia, wherein such oath or affirmation is administered, or by a consular officer of the United States. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those respective services. Income tax returns executed abroad may be attested free of charge before United States consular officers. If a foreign notary or other foreign official having no seal should act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer.

(b) 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 affidavit on the return shall be subscribed and sworn to by such person or persons preparing the return. Such affidavit 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 affidavit is not required if the actual preparation of the return is a regular and usual incident of the employment of one regularly and continuously employed for full time by the person for whom the return is made (as in the case of a clerk, secretary, bookkeeper, accountant, etc.). If, however, the employee is not regularly or continuously employed by the person for whom the return is made for the full time, or the actual preparation of the return is not a regular and usual incident of such employment, the requirements of this paragraph apply. Thus, if the return is prepared by an accountant or firm of accountants making periodical audits of the accounts of the person for whom the return is prepared, the affidavit is required. If the return is a separate return of a married person, the affidavit is required, although the one actually preparing the return is the husband or wife of the taxpayer. A person who renders mere mechanical assistance or preparation as, for example, a stenographer or typist, is not considered as preparing the return. If, in the course of his official duties, a deputy collector, an internal revenue agent, or other officer or employee of the Bureau of Internal Revenue actually prepares the return, the person for whom the return is made shall make in the return a brief statement to that effect, and it will not be necessary to make the sworn statement required by this pararaph.

§ 29.51-5 *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Returns which have not been so prepared will not be accepted as meeting the requirements of the 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 §§ 29.53-2 to 29.53-4, inclusive.)

SEC. 52. CORPORATION RETURNS [as amended by sec. 159 (f), Rev. Act, 1942.]

(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.

§ 29.52-1 *Corporation returns.* Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120. For returns of insurance companies, see §§ 29.201 (b)-1, 29.204 (a)-1, and 29.207-7; of foreign corporations, see section 235; and of affiliated corporations, see section 141 and § 29.141-1. 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 collector be relieved from the necessity of making a return as long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. For information returns by corporations contemplating dissolution or liquidation, see section 148 (d). For information returns by corporations of distributions in liquidations, 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 §§ 29.51-4 and 29.51-5.

§ 29.52-2 *Returns by receiver.* 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 §§ 29.274-1 and 29.274-2.) A receiver in charge of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.

SEC. 53. TIME AND PLACE FOR FILING RETURNS.

(a) *Time for filing*—(1) *General rule.* Returns made on the basis of the calendar year shall be made on or before the 15th day of March following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the third month following the close of the fiscal year.

(2) *Extension of time.* The Commissioner may grant a reasonable extension of time for filing returns, under such rules and regulations as he shall prescribe with the approval of the Secretary. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) *To whom return made*—(1) *Individuals.* Returns (other than corporation returns) shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

(2) *Corporations.* Returns of corporations shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

§ 29.53-1 *Time for filing returns.* Returns of income (except in the case of nonresident alien individuals, as to which see section 217, and foreign corporations, as to which see section 235, and except in the case of a return for a fractional part of a year) must be made on or before the 15th day of the third month following the close of the taxable year. The return by a taxpayer (other than a nonresident alien individual or nonresident foreign corporation) for a fractional part of a year beginning in 1942 and ending in that year shall be filed on or before March 15, 1943. In all other cases, the return (other than a return by a nonresident alien individual or foreign corporation) for a fractional part of a year shall be filed on or before the 15th day of the third full calendar month following the close of the fractional part of a year, except that upon a showing by the taxpayer of unusual circumstances, the Commissioner may prescribe a later time for the filing of the return. In such a case, the time prescribed by the Commissioner shall not be later than the 15th day of the fifteenth month ending after the beginning of such fractional part of a year. A corporation going into liquidation during any taxable year may, upon the completion of such liquidation, prepare a return for that year covering its income for the part of the year during which it was engaged in business and may immediately file such return with the collector. See also section 148 (d) and (e). For provisions relating to certain cases in which the time for filing income tax returns is postponed by reason of a member (whether or not the taxpayer) of the military or naval forces of the United States serving on sea duty or outside the continental United States, by reason of any other individual (whether or not the taxpayer) being outside the Americas, or by reason of a locality being an area of enemy action or control, see Part 472 of this chapter.[1] See such part also for the circumstances under which the time for filing income tax returns of the spouses of such members or of such other individuals is in certain cases postponed. See such part also as to the time for filing income tax returns of China Trade Act corporations.

§ 29.53-2 *Extensions of time for filing returns.* It is important that the taxpayer render on or before the due date a return as nearly complete and final as it is possible for him to prepare. However, the Commissioner is authorized to grant a reasonable extension of time for filing returns under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extensions of time for filing income tax returns is hereby delegated to the various collectors of internal revenue. Application for extensions of time for filing income tax returns should be addressed to the collector of internal revenue for the district in which the taxpayer files his returns and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing income tax returns may be granted for more than six months. For extensions of time for payment of tax, see sections 56 (c) and 272 (j) and §§ 29.53-3, 29.56-2, and 29.272-3.

§ 29.53-3 *Extensions of time in the case of foreign organizations, certain do-*

[1] 8 F.R. 9602.

mestic corporations, citizens of United States residing or traveling abroad, and nontaxable returns of fiduciaries for estates or trusts. (a) An extension of time for filing returns of income for taxable years beginning after December 31, 1941, 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:

(1) Foreign partnerships regardless of whether they maintain an office or place of business within the United States;

(2) Foreign corporations which maintain an office or place of business within the United States;

(3) Domestic corporations which transact their business and keep their records and books of account abroad;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States; and

(5) 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.

(b) An extension of time for filing nontaxable returns of income for taxable years beginning after December 31, 1941, is hereby granted up to and including the 15th day of the fifth month following the close of the taxable year in the case of fiduciaries for estates or trusts. The extension so granted is not applicable to returns of beneficiaries or other distributees of such estates or trusts.

§ 29.53-4 *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, in the case of certain taxpayers to which section 3804 or 3805 is applicable, the provisions of such section and the regulations prescribed thereunder (see Part 472 of this chapter[1]), or the last day of the period covered by an extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the due date for filing returns will be the day following such Sunday or legal holiday. If placed in the mails, the returns should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. If a question may be raised as to whether the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

[1] 8 F.R. 9602.

§ 29.53-5 *Place for filing individual returns.* Section 53 (b) (1) provides that individual returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Md.

An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of section 53 (b) (1), and shall make his return to the collector for the district in which is located his legal residence, or, if he has no legal residence in the United States, then to the collector at Baltimore, Md.

SEC. 54. RECORDS AND SPECIAL RETURNS.

(a) *By taxpayer.* Every person liable to any tax imposed by this 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 shall prepare such copy. Such amount shall be collected and paid, without interest, in the same manner as the amount of tax due in excess of that shown by the taxpayer upon a return in the case of a mathematical error appearing on the face of the return. Copies of returns filed or prepared pursuant to this subsection shall remain on file for a period of not less than two years from the date they are required to be filed, and may be destroyed at any time thereafter under the direction of the Commissioner.

(e) *Foreign personal holding companies.* For information returns by officers, directors, and large shareholders, with respect to foreign personal holding companies, see sections 338, 339, and 340.

For information returns by attorneys, accountants, and so forth, as to formation, and so forth, of foreign corporations, see section 3604.

§ 29.54-1 *Records and income tax forms.* Every person subject to the tax, except persons whose gross income (a) consists solely of salary, wages, or similar compensation for personal services rendered, or (b) 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. Such books or records shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

Income-tax forms shall be prescribed by the Commissioner and shall be executed and filed in accordance with these regulations and the instructions on the form or issued therewith.

SEC. 55. PUBLICITY OF RETURNS [as amended by sec. 507, 2d Rev. Act 1940; sec 554 (d), Rev. Act 1941].

(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 20, 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 State—(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 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 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.

§ 29.55 (b)-1 *Inspection of returns.* 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.

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, Records Division, Washington, D. C. The request must state (a) the kind of returns it is desired to inspect, (b) the taxable year or years covered by the returns it is desired to inspect, (c) the name of the official, body, or commission by whom or which inspection is to be made, (d) the name of the representative of such official, body, or commission, designated to make the inspection, (e) by specific references, the State tax law which such official, body, or commission is charged with administering and the law under which he, she, or it is so charged, (f) the purpose for which the inspection is to be made, and (g) if the inspection is for the purpose of obtaining information to be furnished to local taxing authorities, (1) the name of the official, body, or commission of any political subdivision of the State, lawfully charged with the administration of the tax laws of such political subdivision, if any, to whom or to which the information secured by the inspection is to be furnished, and (2) the purpose for which the information is to be used by such official, body, or commission.

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.

For inspection of returns, other than on behalf of States or political subdivisions thereof, and furnishing copies of returns so open to inspection, see Subpart F, approved by the President on August 28, 1939, and Subpart H, approved September 20, 1939, of Part 458 of this chapter.

SEC. 56. PAYMENT OF TAX [as amended by sec. 172 (f), Rev. Act 1942; sec. 5 (d), Current Tax Payment Act 1943.]

(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.

(b) *Installment payments.* Except in the case of an 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), the taxpayer may elect to pay the tax in four equal installments, in which case the first installment shall be paid on the date prescribed for the payment of the tax by the taxpayer, the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after such date. If any installment is not paid on or before the date fixed for its payment, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector. [NOTE: The amendment of this provision by sec. 5 (d), Current Tax Payment Act 1943, effective with respect to taxable years beginning after December 31, 1942, added the first clause, "Except * * * is not made applicable),".]

(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, 144, and Part II of Subchapter D.

(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.

§ 29.56-1 *Date on which tax shall be paid.* The tax, unless it is required to be withheld at the source (see sections 143 and 144) or unless it is to be paid by a nonresident alien individual (see section 218) or a foreign corporation not having any office or place of business in the United States (see section 236), is to be paid on or before the 15th day of March following the close of the calendar year, or, if the return is made on the basis of a fiscal year, on or before the 15th day of the third month following the close of such fiscal year. In the case of a return (other than a return by a nonresident alien individual or 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 § 29.53-1). But see § 29.53-3. The tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment either by the 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 collector.

For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of a member (whether or not the taxpayer) of the military or naval forces of the United States serving on sea duty or outside the continental United States, by reason of any other individual (whether or not the taxpayer) being outside the Americas, or by reason of a locality being an area of enemy action or control, see Part 472 of this chapter.[1] See such part also for the circumstances under which the date otherwise prescribed for the payment of the tax or an installment thereof of the spouses of such members or of such other individuals is in certain cases postponed. See such part also as to the time for payment of the tax by China Trade Act corporations.

§ 29.56-2 *Extension of time for payment of the tax or installment thereof.* If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner, at the request of the taxpayer, may grant an extension of time for the payment for a period not to exceed six months from the date prescribed for the payment of such amount, part, or installment, except that the extension may be for a period not to exceed five years from the date prescribed for the payment of the tax in the case of such portion of the amount determined as the tax by the taxpayer which is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c)) of a corporation if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in section 115 (c)), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the amount at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

An application for an extension of time for the payment of such tax should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted, subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a tax unless request therefor is made to the collector on or before the date prescribed for payment of the tax or installment thereof for which the extension is desired, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1130 in an amount not exceeding double the amount of the tax or to furnish other security satisfactory to the Commissioner for the payment of the tax, or installment thereof, on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the tax, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax, or installment thereof. (See section 1126 of the Revenue Act of 1926, as amended.) A request by the taxpayer for an extension of time for the payment of one installment does not operate to procure an extension of time for payment of subsequent installments. Nor does an extension of time for filing a return operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension. If an extension of time for payment of the tax or any installment is granted, the amount, time for payment of which is so extended, shall be paid on or before the expiration of the period of the extension, together with interest at the rate of 6 percent per annum on such amount from the date when the payment should have been made if no extension had been granted until the expiration of the period of the extension. (See section 295.)

§ 29.56-3 *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.

§ 29.56-4 *Receipts for tax payments.* Upon request a collector will give a re-

[1] 8 F.R. 9602.

ceipt for each tax payment. In the case of payments made by check or money order the canceled check or the money order receipt is usually a sufficient receipt. In the case of payments in cash, however, the taxpayer should in every instance require and the collector should furnish a receipt.

SEC. 57. EXAMINATION OF RETURN AND DETERMINATION OF TAX.

As soon as practicable after the return is filed the Commissioner shall examine it and shall determine the correct amount of the tax.

§ 29.57-1 *Examination of return and determination of tax by the Commissioner.* As soon as practicable after returns are filed, they will be examined and the correct amount of the tax determined under such procedure as may be prescribed from time to time by the Commissioner. (See section 272.)

SEC. 58. DECLARATION OF ESTIMATED TAX BY INDIVIDUALS [as added by sec. 5 (a), Current Tax Payment Act 1943].

(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) shall, at the time during the taxable year 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)

(A) in case such individual is single or married but not living with husband or wife: can reasonably be expected to exceed $2,700 for the taxable year; or did exceed $2,700 for the preceding taxable year; or

(B) in case such individual is married and living with husband or wife: can, when added to the gross income which can reasonably be expected to be received by such husband or wife from wages (as so defined), reasonably be expected to exceed $3,500 for the taxable year; or did when added to the gross income of such husband or wife from wages (as so defined) for the preceding taxable year, exceed $3,500 for such preceding taxable year; or

(2) his gross income from sources other than wages (as defined in section 1621)

(A) in case such individual is single or married but not living with husband or wife: can reasonably be expected to exceed $100 for the taxable year and his gross income to be such as will require the making of a return for the taxable year under section 51; or did exceed $100 for the preceding taxable year and such individual either was required to make a return under section 51 or 455 for such preceding taxable year or would have been so required if he had been single during the whole of such preceding taxable year; or

(B) in case such individual is married and living with husband or wife: can, when added to the gross income which can reasonably be expected to be received by husband or wife from such sources, reasonably be expected to exceed $100 for the taxable year and the aggregate gross income of such husband and wife can reasonably be expected to be such as will require the making of a return under section 51 or 455; or did, when added to the gross income of such husband or wife from such sources for the preceding taxable year, exceed $100 for such preceding taxable year and such individual would have been required to make a return under section 51 or 455 for such preceding taxable year if he had been married and living with husband or wife during the whole of such preceding taxable year; or

(3) in case such taxable year is the taxable year beginning in 1943, such individual was required to make a return under section 51 for the taxable year beginning in 1942, and his gross income from wages (as defined in section 1621) for such taxable year is greater than the gross income which can reasonably be expected to be received from wages for the taxable year beginning in 1943.

(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, 35, and 466 (e);

(2) the amount which he estimates as the credits for the taxable year under sections 32, 35, and 466 (e); 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 held and 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.

(c) *Joint declaration by husband and wife.* In the case of a husband and wife living together, 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.

(d) *Time and place for filing.* The declaration required under subsection (a) shall be filed on or before the fifteenth day of the third month of the taxable year, except that if the requirements of subsection (a) are first met after such date, the declaration shall be filed on or before the fifteenth day of the last month of the quarter of the taxable year in which such requirements are first met. An individual may make amendments or revisions of a declaration filed under this subsection, under regulations prescribed by the Commissioner with the approval of the Secretary. If so made, such amendments or revisions shall 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 amendments or revisions have been made or filed. Declarations and amendments and revisions thereof shall be filed with the Collector specified in section 53 (b) (1).

(e) *Extension of time.* The Commissioner may grant a reasonable extension of 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.

(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) *Signature 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. [NOTE: Section 58 is, under sec. 5 (f), Current Tax Payment Act 1943, effective with respect to taxable years beginning after December 31, 1942. The original section 58 consisted of cross-references.]

SEC. 59. PAYMENT OF ESTIMATED TAX [as added by sec. 5 (a), Current Tax Payment Act 1943].

(a) *In general.* The estimated tax shall be paid in four equal installments except that—

(1) if the declaration is filed (otherwise than pursuant to an extension of time) after the fifteenth day of the third month of the taxable year, the estimated tax shall be paid in equal installments the number of which is equal to the number of quarters remaining in the taxable year (including the quarter in which the declaration is filed); and

(2) if any amendment or revision of a declaration is filed, the remaining installments 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 or revision; and

(3) at the election of the individual, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

One installment of the estimated tax shall be paid at the time of making the declaration, and an installment thereof shall be paid on the fifteenth day of the last month of each succeeding quarter of the taxable year. Payment of any installment of the estimated tax shall be considered payment on account of the tax for the taxable year.

(b) *Assessment.* The estimated tax shall be assessed only to the extent paid. [NOTE: Section 59 is, under sec. 5 (f), Current Tax Payment Act 1943, effective with respect to taxable years beginning after December 31, 1942. The original section 59 consisted of cross-references.]

SEC. 60. SPECIAL RULES FOR APPLICATION OF SECTIONS 58 AND 59 [as added by sec. 5 (a), Current Tax Payment Act 1943].

(a) *Farmers.* In the case of an individual whose estimated gross income from farming for the taxable year is at least 80 per centum 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 the fifteenth day of the last month of the taxable year.

(b) *Application to short taxable years.* The application of sections 58, 59, and 294 (a) (3), (4), and (5) 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) *Application to taxable years beginning in 1943.* If the taxable year is the calendar year 1943, the fifteenth day of September, 1943, shall be substituted for the fifteenth day of March for the purposes of section 58 (d). If the taxable year begins in 1943 after January 1, the date which shall be substituted for the fifteenth day of the third month of the taxable year for the purposes of section 58 (d) shall be prescribed by regulations prescribed by the Commissioner with the approval of the Secretary. In either case installments of the estimated tax for such taxable year payable after September 1, 1943, shall be ratably decreased to reflect the payments on account of a taxable year beginning in 1942 which are treated as payments on account of the estimated tax for a taxable year beginning in 1943. [NOTE: Section 60 is, under sec. 5 (f), Current Tax Payment Act 1943, effective with respect to taxable years beginning after December 31, 1942. The original section 60 consisted of cross-references.]

MISCELLANEOUS PROVISIONS

SEC. 61. LAWS MADE APPLICABLE.

All administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, 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 will appear in the issue for Thursday, November 4, 1943. Subparts D, E, F, and G will appear in the issue for Friday, November 5, 1943*]

[SEAL] ROBERT E. HANNEGAN,
Commissioner of Internal Revenue.

Approved: October 26, 1943.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

[F. R. Doc. 43-17458; Filed, October 28, 1943; 9:43 a. m.]

TITLE 30—MINERAL RESOURCES

Chapter VI—Solid Fuels Administration for War

[Reg. 6]

PART 602—GENERAL ORDERS AND DIRECTIVES

DELIVERIES OF ANTHRACITE COAL

The present interruptions in the production of anthracite coal and the fulfilment of requirements for the defense of the United States will create a critical shortage in the supply of anthracite coal for defense, for private account, and for export. In order to insure the equitable distribution of the available supply of anthracite coal, it is necessary as a precautionary measure to place restrictions upon deliveries of anthracite by retail dealers. Accordingly, in order to effectuate the purposes of Executive Order No. 9332 and by virtue of the authority conferred by that order, the following regulation is issued by the Solid Fuels Administrator for War:

§ 602.101 *Definitions.* (a) "Anthracite" means that coal which is generally referred to as Pennsylvania anthracite and is produced in the following counties in Pennsylvania: Carbon, Columbia, Dauphin, Lebanon, Lackawanna, Luzerne, Northumberland, Schuylkill, Susquehanna, and Wayne; and is limited to the sizes generally known as broken, egg, stove, chestnut, pea, No. 1 buckwheat and No. 2 buckwheat (rice).

(b) "Retail dealer" means any person who purchases anthracite for resale to consumers.

(c) "Ten days' supply" includes all anthracite coal of any usable kind, grade or size in the consumer's bin required by reasonable estimate to meet minimum anthracite requirements of the consumer for a ten-day period.

§ 602.102 *Restrictions upon anthracite deliveries by retail dealers.* (a) No retail dealer shall deliver any anthracite coal to any consumer if such consumer has more than a ten days' supply; and no consumer shall accept delivery of any anthracite coal from a retail dealer if such consumer has more than a ten days' supply.

(b) A retail dealer may deliver anthracite coal up to but not in excess of one-half ton to any household consumer if such consumer has less than a ten days' supply.

(c) The restrictions of this section shall apply regardless of whether any consumer had title to any coal in the possession of any retail realer on the effective date of this regulation.

§ 602.103 *Contemplated activities of local committees of the office of Defense Transportation.* (a) It is understood that local committees functioning under the direction of the Office of Defense Transportation will, during the period of work stoppages in the anthracite producing districts and during the effective period of this Regulation, ascertain the amount of anthracite in retail yard storage piles in their communities, will arrange for the pooling of retail dealer deliveries and will coordinate in other ways retail dealer activities in each anthracite consuming community.

(b) It is understood that the local committees functioning under the direction of the Office of Defense Transportation will indicate to the regional offices of the Solid Fuels Administration for War the tonnages of anthracite coal critically needed by those communities having insufficient anthracite to forestall suffering threatened by weather conditions. The Solid Fuels Administrator for War will, upon the recommendation of such local committees, arrange, so far as practicable and appropriate, for the shipment of sufficient tonnages of anthracite that is now being held, pursuant to direction of the Solid Fuels Administration for War, in the anthracite producing districts for distribution into those communities whose need for anthracite appears to be critical.

§ 602.104 *Deliveries are not authorized under Office of Price Administration Ration Order No. 19 in contravention of this regulation.* As provided in section 15 of Ration Order No. 19 issued by the Office of Price Administration, no deliveries are authorized to be made under the provisions of that ration order in contravention of the provisions of this regulation.

§ 602.105 *Violations.* Any person who wilfully violates any provisions of this regulation is guilty of a crime, and upon conviction may be punished by fine or imprisonment. In addition, any such person may be prohibited from making or obtaining further deliveries of, or from processing or using material under priority control and may be deprived of priorities assistance.

§ 602.106 *Communications.* All communications regarding this regulation should be addressed to the Solid Fuels Administrator for War, Washington, D. C.

This regulation shall become effective immediately.

(E.O. 9332, 8 F.R. 5355; E.O. 9125, 7 F.R. 2719; sec. 2 (a), 54 Stat. 676, as amended by 55 Stat. 236 and 56 Stat. 176)

Issued this 30th day of October 1943.

ABE FORTAS,
Acting Solid Fuels Administrator for War.

[F. R. Doc. 43-17706; Filed, November 2, 1943; 9:23 a. m.]

[Reg. 6, Amdt. 1]

PART 602—GENERAL ORDERS AND DIRECTIVES

DELIVERIES OF ANTHRACITE COAL

It is necessary to amend Solid Fuels Administration for War Regulation No. 6 in order to prevent the imposition of undue distribution difficulties upon retail dealers of anthracite coal who serve as a source of supply for larger consumers of anthracite. Accordingly, pursuant to powers conferred by Executive Order No. 9332, Solid Fuels Administration for War Regulation No. 6 is hereby amended as follows.

1. Section 602.102 (b) is amended to read as follows:

§ 602.102 *Restrictions upon anthracite deliveries by retail dealers.* * * *

(b) A retail dealer may deliver anthracite coal up to but not in excess of one-half ton to any household consumer if such consumer has less than a ten days' supply. A retail dealer may deliver anthracite coal in any quantity to other than household consumers provided that the tonnage delivered, when added to the inventory on hand, does not exceed a ten days' supply.

This amendment shall become effective immediately.

Issued this 1st day of November 1943.

HAROLD L. ICKES,
Solid Fuels Administrator for War.

[F. R. Doc. 43-17707; Filed, November 2, 1943; 9:29 a. m.]

TITLE 32—NATIONAL DEFENSE

Chapter XI—Office of Price Administration

PART 1351—FOOD AND FOOD PRODUCTS

[MPR 480]

EDIBLE TREE NUTS

This regulation establishes maximum prices for certain sales of edible tree nuts, both in-shell and shelled, in order to aid in stabilizing the cost of living.

THE NATIONAL ARCHIVES OF THE UNITED STATES 1934

FEDERAL REGISTER

VOLUME 8 NUMBER 219

Washington, Thursday, November 4, 1943

Regulations

TITLE 6—AGRICULTURAL CREDIT

Chapter II—War Food Administration (Commodity Credit)

[1943 C.C.C. Bran and Pea Form 1, Supp. 2]

PART 237—1943 BEAN AND PEA LOANS AND PURCHASES

INSTRUCTIONS CONCERNING BEAN PURCHASES BY COUNTY A.A.A. COMMITTEES

Pursuant to the provisions of Title III, section 302 of the Agricultural Adjustment Act of 1938, as amended (52 Stat. 43; 7 U.S.C., 1940 ed., 1302), Commodity Credit Corporation has authorized the making of loans on dry edible beans and dry edible smooth peas stored on farms in approved storage structures or in approved warehouses, in accordance with the regulations in this part (1943 C.C.C. Bean and Pea Form 1—Instructions). Such regulations are hereby supplemented by the addition, under "C. Purchases", of § 237.38 entitled "Bean purchases by County A.A.A. Committees", reading as follows:

§ 237.38 *Bean purchases by County A.A.A. Committees*—(1) *Eligible beans.* Eligible beans shall be beans produced in 1943, of the classes specified herein, which grade No. 1 and No. 2 or which can be cleaned or cleaned and picked to grade No. 2 or better.

(2) *Eligible producers.* An eligible producer shall be any person, partnership, association or corporation producing dry edible beans in 1943 as landowner, landlord, or tenant.

(3) *Program outline.* In order to handle this year's record crop of beans in an orderly and efficient manner, and assure producers of the announced support prices, it is necessary that we have close cooperation between country shippers, the county A.A.A. committee, the Food Distribution Administration, and Commodity Credit Corporation. County committees should contact country dealers to determine if they will cooperate with the 1943 Bean Program by signing a 1943 C.C.C. Edible Bean Form A, and shall also determine the quantity of beans the country shippers and country buyers in their counties can handle. Every effort should be made by county committees to have all beans purchased by country shippers. If beans are offered for sale to a country shipper, or country buyer, by a producer at the support price, less applicable charges, and the shipper or buyer does not purchase them, or if there are no country shippers or country buyers to purchase beans, arrangements should be made by county committees to purchase beans up to the capacity of C.C.C. bins or available warehouse storage, or for immediate shipment, as directed by Commodity Credit Corporation.

(4) *Purchases of beans.* County A.A.A. committees shall receive beans from the producer and draw a representative sample in cooperation with the producer. Such sample shall be mailed to the State A.A.A. laboratory or to a laboratory licensed to grade beans. The beans shall be stored in C.C.C. bins or shipped in accordance with shipping instructions from C.C.C. Payment for the beans shall be made by means of a sight draft drawn on C.C.C. in the manner designated by the producer, for the amount determined by the quantity, class, and grade of beans delivered, less applicable charges for cleaning, bags, bagging, labeling, and other charges, as stated in 1943 C.C.C. Bean Form A. The draft shall be issued by the county committees upon receipt of the analysis of the producer's beans, and the information on the scale tickets and inspection certificates is to be transferred to the sight draft. The draft is to be prepared in triplicate, the original to be issued to the producer, the first copy to be sent to the regional director of Commodity Credit Corporation on the date of preparation, and the second copy to be retained in the county office. In the event the county committee purchases a carload of beans for immediate shipment, the copies of the sight draft sent to the regional director of Commodity Credit Corporation shall be accompanied by the original bills of lading. The sight draft may be presented by the producer to a local bank or mailed to the regional office of Commodity Credit Corporation for collection. County A.A.A. committees shall send weekly reports, on Commodity Loan 23-A, of all beans purchased and placed in C.C.C. bins, to the

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TITLE 26—INTERNAL REVENUE

Chapter I—Bureau of Internal Revenue

Subchapter A—Income and Excess-Profits Taxes

[Regulations 111]

PART 29—INCOME TAX; YEARS BEGINNING AFTER DECEMBER 31, 1941

NOTE: The table of contents and Subparts A and B appeared in the issue of Wednesday, November 3, 1943.

SUBPART C—SUPPLEMENTAL PROVISIONS

RATES OF TAX

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS [as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

The following organizations shall be exempt from taxation under this chapter—

§ 29.101-1 *Proof of exemption.* A corporation is not exempt merely because it is not organized and operated for profit. In order to establish its exemption it is necessary that every organization claiming exemption file with the collector for the district in which is located the principal place of business or principal office of the organization an affidavit or a questionnaire 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 questionnaire appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following questionnaire forms may be obtained from any collector: For corporations 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 affidavit 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 affidavit or questionnaire 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. An organization claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14) shall also file with the other information specified herein a return of information on Form 990 relative to the business of the organization for the last complete year of operation: *Provided, however,* That such return shall not be required of an organization which is organized and operated exclusively for educational purposes, or educational and religious purposes, if no part of its net earnings or assets are distributable to any private shareholder in liquidation or otherwise and if, in the case of an organization privately owned or operated, the Commissioner is advised of any increase in the compensation of its owners, managers, trustees, or directors over the amount of such compensation for the last year for which its exemption under section 101 (6) was approved by the Commissioner. Form 990 will not be required of charitable organizations operated or controlled by religious or educational organizations of the type exempt under the preceding sentence from the requirement of filing such returns, nor of separately conducted charitable organizations meeting the above conditions as to distributions and compensation, nor of charitable organizations operated under the control of a State or any political subdivision thereof.

The words "private shareholder or individual" in section 101 refer to individuals having a personal and private interest in the activities of the corporation. Although religious or apostolic associations or corporations exempt under section 101 (18) are relieved from paying the tax, they are required to file returns of income (see § 29.101 (18)-1).

In the case of the particular classes of organizations listed below, the following additional information shall be embodied in or attached to, and made a part of, the affidavit or questionnaire referred to above:

(a) Mutual insurance companies shall submit copies of the policies or certificates of membership;

(b) 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 Bureau of Internal Revenue 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.

The collector, upon receipt of the affidavit, or questionnaire, and other papers, will examine them as to completeness and will forward completed documents to the Commissioner for decision as to whether the organization is exempt. In addition to the information specified herein, 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 provide additional questionnaires or otherwise prescribe the form in which the proof of exemption shall be furnished.

When an organization (other than a mutual insurance company) has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created, except that every organization exempt or claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14) shall file annually returns of information on Form 990 with the collector for the district in which is located the principal place of business or principal office of the organization: *Provided, however,* That such return shall not be required of an organization which is organized and operated exclusively for educational purposes, or educational and religious purposes, if no part of its net earnings or assets are distributable to any private shareholder in liquidation or otherwise and if, in the case of an organization privately owned or operated, the Commissioner is advised of any increase in the compensation of its owners, managers, trustees, or directors over the amount of such compensation for the last year for which its exemption under section 101 (6) was approved by the Commissioner. Form 990 will not be required of charitable organizations operated or controlled by religious or educational organizations of the type exempt under the preceding sentence from the requirement of filing such returns, nor of separately conducted charitable organizations meeting the above conditions as to distributions and compensation, nor of charitable organizations operated under the control of a State or any political subdivision thereof. The return of information on Form 990 shall be filed on or before the 15th day of the fifth month following the close of the taxable year. When a mutual insurance company has established its right to exemption under section 101 (11) of the Internal Revenue Code or a corresponding provision of a prior income tax law it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or unless the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) exceeds $75,000. See § 29.101 (18)-1 with respect to returns by religious or apostolic associations or corporations exempt under section 101 (18). See also sections 275 (a) and 276 (a) with respect to the statute of limitations.

Collectors will keep a list of all organizations held to be exempt to the end that they may occasionally inquire into their status and ascertain whether or not

they are observing the conditions upon which their exemption is predicated.

An organization which is exempt under section 101 and the regulations thereunder, from filing returns of income is not, however, relieved from the duty of filing returns of information (see sections 147 and 148).

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act, 1939; secs. 137 (a), 165 (a), Rev. Act, 1942.]

[The following organizations shall be exempt from taxation under this chapter—]

(1) Labor, agricultural, or horticultural organizations;

§ 29.101 (1)-1 *Labor, agricultural, and horticultural organizations.* The organizations contemplated by section 101 (1) as entitled to exemption from income taxation are those which:

(a) Have no net income inuring to the benefit of any member;

(b) Are educational or instructive in character; and

(c) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations which have for their purpose, for example, the holding of periodical race meets, the profits from which may inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act. 1942.]

[The following organizations shall be exempt from taxation under this chapter—]

(2) Mutual savings banks not having a capital stock represented by shares;

§ 29.101 (2)-1 *Mutual savings banks.* In order that a corporation may be entitled to exemption as a mutual savings bank, it must appear that it is an organization:

(a) Which has no capital stock represented by shares, and

(b) Whose earnings, less only the expenses of operation, are distributable wholly among the depositors.

If it appears that the organization has shareholders who participate in the profits, the organization will not be exempt.

A mutual savings bank need not be incorporated or be under public supervision, unless, in either case a State statute so requires, nor need it serve the public in general, in order to be exempt. It may confine its business to a designated class of individuals, such as employees of a single corporation, without losing its exempt status.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act. 1939; secs. 137 (a), 165 (a), Rev. Act. 1942.]

[The following organizations shall be exempt from taxation under this chapter—]

(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;

§ 29.101 (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.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[The following organizations shall be exempt from taxation under this chapter—]

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

§ 29.101 (4)-1 *Building and loan associations and cooperative banks.* A building and loan association organized pursuant to and operating in accordance with the laws of the United States or a State or Territory thereof, substantially all the business of which association is confined to making loans to members, is entitled to exemption.

Cooperative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions such as those organized under the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; Secs. 137 (a), 165 (a), Rev. Act. 1942.]

[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;

§ 29.101 (5)-1 *Cemetery companies.* A cemetery company may be entitled to exemption:

(a) 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

(b) If it is not operated for profit.

Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual. A cemetery company which fulfills the other requirements of the 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.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act. 1942.]

[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;

§ 29.101 (6)-1 *Religious, charitable, scientific, literary, and educational organizations and community chests.* In order to be exempt under section 101 (6), the organization must meet three tests:

(a) It must be organized and operated exclusively for one or more of the specified purposes;

(b) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(c) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

An educational organization within the meaning of the 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.

Since a corporation to be exempt under section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufacturers and sells articles to the public for profit, is not exempt under section 101 (6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. See section 101 (18) as to religious or apostolic associations or corporations.

A corporation otherwise exempt under section 101 (6) does not lose its status as an exempt corporation by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.

[SEC. 101. *Exemptions from tax on corporations*—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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 share holder or individual;

§ 29.101 (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.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act. 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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;

§ 29.101 (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 (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. See § 29.101 (6)-1 with reference to the meaning of "charitable" and "educational" and § 29.101 (10)-1 as to the meaning of "local" as used in the Code.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act, 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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;

§ 29.101 (9)-1 *Social clubs.* The exemption granted by section 101(9) applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club engages in traffic, in agriculture or horticulture, or in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. Generally, an incidental sale of property will not deprive the club of the exemption.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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;

§ 29.101 (10)-1 *Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.* It is a prerequisite to exemption under section 101 (10) that at least 85 percent of the income of the organization shall consist of amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 101 (10). It applies, however, to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State, it cannot be considered to be purely local in character.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a) Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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;

§ 29.101 (11)-1 *Mutual insurance companies or associations.* An insurance company is exempt from taxation under this chapter 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. Such a company is not required to file income-tax returns or pay income taxes.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; Secs. 137 (a), 165 (a), Rev. Act 1942.]

[The following organizations shall be exempt from taxation under this chapter—]

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less than 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 their 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;

§ 29.101 (12)-1 *Farmers' cooperative marketing and purchasing associations.* (a) 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 and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Internal Revenue Code and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the 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.

An association which has capital stock will not for such reason be denied exemption (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of 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). 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.

[Sec. 101. Exemptions from tax on corporations—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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; .

§ 29.101 (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 § 29.101 (12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217 (a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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:

(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 investments;

(18) Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro-rata shares, whether distributed or not, of the net income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

§ 29.101 (18)-1 *Religious or apostolic associations or corporations.* Religious or apostolic associations or corporations are exempt from taxation under chapter 1 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 include (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101 (18) and this section shall make for each taxable year a return stating specifically the items of its gross income and deductions, and its net income, and there shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the net income of the association or corporation for such year. If the taxable year of any member is different from the taxable year of the association or corporation, the distributive share of the net income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the net income of the association or corporation for the taxable year of the association or corporation ending within the taxable year of the member.

[SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS—as amended by sec. 217(a), Rev. Act 1939; secs. 137 (a), 165 (a), Rev. Act 1942.]

[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.

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS [as amended by sec. 211 (f), Rev. Act 1939; secs. 103 (d), 202 (b), Rev. Act 1941; secs. 105 (e), 135 (b), 138, Rev. Act 1942.]

(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 permited 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.

(C) *Disallowed losses.* Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) *Income subject to excess-profits tax.* The credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e).

(2) *Undistributed section 102 net income.* The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

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

§ 29.102-1 *Taxation of corporation formed or utilized for avoidance of surtax.* Section 102 imposes (in addition to other taxes imposed by chapter 1) 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 forma-

tion or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

A foreign corporation, whether resident or nonresident, formed or availed of for the purpose specified in section 102 is subject to the tax imposed thereby if it derives income from sources within the United States as defined in section 119 and the regulations thereunder, if any of its shareholders are (1) citizens or residents of the United States and therefore subject to the surtax with respect to distributions of the corporation or (2) nonresident alien individuals who, by the application of section 211 (b) or section 211 (c), would be subject to the surtax with respect to distributions of the corporation which if made would constitute income from sources within the United States (see section 119) or (3) foreign corporations if any beneficial interest therein is owned directly or indirectly by any shareholder specified in (1) or (2). On the other hand, the tax imposed by section 102 will not apply even though a foreign corporation, whether resident or nonresident derives income from sources within the United States, if all of its shareholders are nonresident alien individuals who, by the application of section 211 (a), would not be subject to surtax with respect to distributions of the corporation if made.

For the computation of the surtax see § 29.102-4.

§ 29.102-2 *Purpose to avoid surtax; evidence; burden of proof; definition of holding or investment company.* The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the 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.

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 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 evidence that the absence of such a purpose is unmistakable.

A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

§ 29.102-3 *Unreasonable accumulation of profits.* An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income 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.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated earnings and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

§ 29.102-4 *Computation of undistributed section 102 net income.* In ascertaining the tax basis for corporations subject to the provisions of section 102,

the "section 102 net income" is first computed. This is accomplished in the case of a domestic corporation by subtracting from the corporate net income (as defined in sections 21 and 204) computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year beginning after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), (a) 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 (c), but not including the graduated income tax or surtax imposed by section 102 or corresponding sections of prior Revenue Acts; (b) contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) and § 29.23 (o)-1 for the purposes therein specified; (c) losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d) for the taxable year. In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return the "section 102 net income" means the net income from sources within the United States (gross income from sources within the United States, as defined in section 119 and the regulations thereunder, less statutory deductions) minus the amount of the deductions enumerated in (a), (b), and (c) above. In the case of a foreign corporation, whether resident or nonresident, which files no return the "section 102 net income" means the gross income from sources within the United States, as defined in section 119 and the regulations thereunder, without the benefit of the deductions enumerated in (a), (b), and (c) above, or any other deductions. (See section 233.) 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).

The "section 102 net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "section 102 net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

The "undistributed section 102 net income" is computed by subtracting from the "section 102 net income" described above, the amount of the basic surtax credit provided in section 27 (b). In computing the basic surtax credit for the purpose of section 102, the credit under section 27 (b) (1) is not to be reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

SEC. 103. RATES OF TAX ON CITIZENS AND CORPORATIONS OF CERTAIN FOREIGN COUNTRIES [as amended by secs. 163 (b), 172 (c), Rev. Act 1942].

Whenever the President finds that, under the laws of any foreign country, citizens or corporations of 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 450 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 450, as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 per centum of the net income of the taxpayer. Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

SEC. 104. BANKS AND TRUST COMPANIES [as amended by sec. 202, Rev. Act 1939; sec. 104 (c), Rev. Act 1941.]

(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, § 248k), as amended, and which is subject by law to supervision and examination by State, Territorial or Federal authority having supervision over banking institutions.

(b) *Rate of tax.* Banks shall be subject to tax under section 13 or section 14 (b), and under section 15.

§ 29.104-1 *Tax on banks.* A bank, as defined in section 104 (a), is, under section 104 (b), subject to the tax imposed by section 13 if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b) if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a bank is also subject to the surtax imposed by section 15 (see § 29.15-1).

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.

§ 29.105-1 *Surtax on sale of oil or gas properties.* If the taxpayer by prospecting and locating claims, or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by section 12 attributable to a sale of such property or of the taxpayer's interest therein shall not exceed 30 percent of the selling price. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 105 to a particular case, the taxpayer should first compute the surtax imposed by section 12 upon his entire surtax net income, including the net income from any sale of such property or interest therein, without regard to section 105. The proportion of the surtax, so computed, indicated by the ratio which the taxpayer's net income from the sale of the property or interest therein, computed as prescribed in this 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.

In determining the portion of the net income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the net income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

SEC. 106. CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITION OF PROPERTY.

In the case of amounts (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than fifteen years, the portion of the tax imposed by section 12 attributable to such receipt shall not exceed 30 per centum of the amount (other than interest) so received.

§29.106-1 *Surtax on certain amounts received from the United States.* The method of computation provided for in § 29.105-1, 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.

SEC. 107. COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF THIRTY-SIX MONTHS OR MORE [as added by sec. 220 (a), Rev. Act 1939, and as amended by sec. 139 (a), Rev. Act 1942.]

(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.

§ 29.107-1 *Personal services.* 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, 1942, and completes them on July 1, 1945, 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 1945 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, 1942, to July 1, 1945. However, if such individual receives an additional $5,000 in 1946 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, 1940, and completes them on August 22, 1943, and is paid a total compensation of $10,000 for such services on July 5, 1942, he is entitled to the benefits of section 107 (a); and the tax attributable to the $10,000 received in 1942 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, 1940, to July 5, 1942, the date on which the $10,000 was received. However, if such individual receives an additional $7,000 for such services on May 1, 1943, 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.

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.

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.

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.

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.

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 the second preceding paragraph) 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 the preceding paragraph), which ever is the smaller.

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, 1942, 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, 1939, and ending on September 30, 1942. 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 1942, $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 1939, $12,000 to 1940, $12,000 to 1941, and $9,000 to 1942 (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, 1939, $12,000 each to the taxable years ended June 30, 1940, June 30, 1941, and June 30, 1942, and $3,000 to the taxable year ending June 30, 1943 (the current taxable year).

Example (3). Assume the same facts as in example (1) except that A receives the $40,000 on February 1, 1942 (before completion of the services), instead of November 1, 1942. 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, 1939, to February 1, 1942. Thus $8,750 is allocated to 1939, $15,000 to 1940, $15,000 to 1941, and $1,250 to 1942 (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, 1939, and ending on August 31, 1942. The total compensation for such services is $74,000, of which $34,000 is paid to B on March 1, 1942, and $40,000 on August 31, 1942. 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 1939, $12,000 to 1940, $12,000 to 1941, and $8,000 to 1942 (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, 1942). Accordingly, with respect to the $34,000 payment, $8,000 is allocated to 1939, $12,000 to 1940, $12,000 to 1941, and $2,000 to 1942 (the current taxable year). The entire compensation of $74,000 will, therefore, be allocated as follows: $16,000 to 1939, $24,-000 to 1940, $24,000 to 1941, and $10,000 to 1942 (the current taxable year).

If an individual, in computing his income tax for a particular taxable year, avails himself of the benefits of section 107 (prior or subsequent to its amendment by section 139 of the Revenue Act of 1942) 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, 1937, and completes them on December 31, 1941. On December 31, 1941, he receives $60,000 in full compensation therefor. In his return for the calendar year 1941, 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, 1939, and completes them on December 31, 1942. On December 31, 1942, 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 1942, 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 1939, 1940, and 1941, 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 1941.

§ 29.107-2 *Artistic work or invention.* Section 107 (b) provides that 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 (1) the gross income therefrom in the taxable year, and (2) 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 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.

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.

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 artisic work or invention is the difference between the tax for such year computed with the inclusion in gross income 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.

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 the second preceding paragraph) 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 the preceding paragraph).

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, 1942, 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, 1938, and completed on January 29, 1943. 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 1942 (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, 1943. Accordingly, $12,000 is allocated to 1940, $12,000 to 1941, and $12,000 to 1942 (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, 1941, and completed on September 1, 1944. 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 1942 (the current taxable year). Therefore, $2,000 ($36,000 divided by 18) must be allocated to each of 18 calendar months preceding January 1, 1943. Accordingly, $12,000 is allocated to 1941, and $24,000 to 1942 (the current taxable year).

The principles set forth in the last paragraph of § 29.107-1, 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).

SEC. 108 [Added by sec. 140 (a), Rev. Act 1942—not applicable to taxable years beginning after December 31, 1941].

SEC. 109. WESTERN HEMISPHERE TRADE CORPORATIONS [as added by sec. 141, Rev. Act 1942].

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.

§ 29.109-1 *Western hemisphere trade corporations.* Under the provisions of section 15 a domestic corporation qualifying as a Western Hemisphere trade corporation is exempt from the surtax imposed upon corporations generally by section 15. To so qualify, the following tests must be met:

(a) 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

(b) 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

(c) 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 exemption 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.

A corporation which claims exemption 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 3-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.

COMPUTATION OF NET INCOME

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.

§ 29.111-1 *Computation of gain or loss.* 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 §§ 29.113 (b) (1)-1 to 29.113 (b) (3)-2, 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.

Even though property is not sold or otherwise disposed of, gain (includible in gross income under section 22 (a) as "gains or profits and income derived from any source whatever") is realized if the sum of all the amounts received which are required by section 113 (b) to be applied against the basis of the property exceeds such basis. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof the Internal Revenue Code takes no account of it. The provisions of this paragraph may be illustrated by the following example:

Example. A purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1942, 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 1942 a further distribution of $5,000, being a distribution described in section 113 (b) (1) (D). This distribution applied against the adjusted basis as required by section 113 (b) (1) (D) exceeds that basis by $4,000. The amount of the excess, namely, $4,000, is a gain realized by A in 1942 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 1943 for $5,000, he realizes in 1943 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 44.

SEC. 112. RECOGNITION OF GAIN OR LOSS [as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(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.

§ 29.112 (a)-1 *Sales or exchanges.* The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the 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.

The Internal Revenue Code makes specific provision for the case in which, in addition to property which m[illegible] be received tax free on the exchange, there is received as boot other property or money.

In such a case gain is recognized to the extent of the boot (see section 112 (c) and (d)), but no loss of any kind is recognized (see section 112 (e)).

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the 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.

To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

See section 112 (b) (6) 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 (53 Stat. 1183), 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.

§ 29.112 (a)-2 *Use of term "assumption of liabilities."* When used in the regulations prescribed under sections 112 and 113, the terms "assumption of liabilities," "liablities assumed," or similar expressions include, in addition to cases where personal liabilities of the taxpayer are assumed by another party to the exchange, cases (1) 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 (2) 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.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142(a), 151(d) (e), Rev. Act 1942.]

(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 for productive use in trade or business or for investment.

§ 29.112 (b) (1)-1 *Property held for productive use in trade or business or for investment.* As used in section 112 (b) (1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under 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 dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

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).

Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

[(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.

§ 29.112 (b) (2)-1 *Stock for stock of the same corporation.* The exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation is not limited to a transaction between a stockholder and the corporation; it includes an exchange between two individual stockholders. However, the provisions of section 112 (b) (2) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation.

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).

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

[(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.

§ 29.112 (b) (5)-1 *Transfer of property to corporation controlled by transferor.* As used in section 112 (b) (5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 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.

Example (1). A owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $150,000 in 1942. He transfers this property to the M. Corporation, a newly formed company, for all the latter's capital stock. No gain or loss is recognized on the transaction.

Example (2). C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example (3). B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1942. He transfers the property to the N Corporation in 1942 for 78 percent of each class of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112 (h).)

§ 29.112 (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 the regulations prescribed thereunder.

(b) *Computation of proportionate interests required by section 112 (b) (5).* 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 transferors are sustantially 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. The application of this paragraph may be illustrated by the following example:

Example. A and B, individuals, each owns property with a fair market value of $100,000 on July 1, 1942. There is a purchase money mortgage on A's property of $50,000. On July 1, 1942, 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.

§ 29.112 (b) (5)-3 *Records to be kept and information to be filed.* Every person who receives the stock or securities of a controlled corporation for property under section 112 (b) (5) shall file with his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(a) 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

(b) 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.

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).

Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange under section 112 (b) (5) showing the cost or other basis in his hands of the transferred property, and of the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received in the exchange.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

[(b) *Exchanges solely in kind*—]

(6) *Property received by corporation on complete liquidation of another.* No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and collection of all income, war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

§ 29.112 (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 an-

other corporation and provides for the nonrecognition of gain or loss in these 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 § 29.113 (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.

The provisions of section 112 (b) (6) do not apply to any liquidation if any distribution in pursuance thereof has been made before the first day of the first taxable year of the recipient corporation beginning after December 31, 1935.

To constitute a distribution in complete liquidation within the meaning of section 112 (b) (6), the distribution must be (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 § 29.22 (a)-20.)

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). The application of this paragraph may be illustrated by the following example:

Example. On July 1, 1942, 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, 1942, 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, 1942, pursuant to a plan of liquidation adopted on July 1, 1942, 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.

§ 29.112 (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 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 § 29.112 (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).

§ 29.112 (b) (6)-3 *Liquidations covering more than one taxable year.* If the plan of liquidation is consummated by a series of distributions covering a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall, in addition to the requirements of § 29.112 (b) (6)-1, be subject to the following requirements:

(a) In order for the distribution in liquidation to be brought within the exception provided in section 112 (b) (6) to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred in accordance with a plan of liquidation, which plan shall include a statement showing the period within which the transfer of the property of the liquidating corporation to the recipient corporation is to be completed. The transfer of all the property under the liquidation must be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.

(b) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall, at the time of filing its return, file with the collector for transmittal to the Commissioner a waiver of the statute of limitations on assessment. The waiver shall be executed on such form as may be prescribed by the Commissioner and shall extend the period for assessment of all income and profits taxes for each such year to a date not earlier than one year after the last date of the period for assessment of such taxes for the last taxable year in which the transfer of the property of the liquidating corporation to the controlling corporation may be completed in accordance with section 112 (b) (6). Such waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be necessary to insure the assessment and collection of the correct tax liability for each year within the period of liquidation.

(c) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall file a bond, the amount of which shall be fixed by the Commissioner. The bond shall contain all terms specified by the Commissioner, including provisions unequivocally assuring prompt payment of the excess of income and profits taxes (plus penalty, if any, and interest) as computed by the Commissioner without regard to the provisions of sections 112 (b) (6) and 113 (a) (15) over such taxes computed with regard to such provisions, regardless of whether such excess may or may not be made the subject of a notice of deficiency under section 272 and regardless of whether it may or may not

be assessed. Any bond required under section 112 (b) (6) shall have such surety or sureties as the Commissioner may require. However, see section 1126 of the Revenue Act of 1926, as amended, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal bonds will be approved as sureties. The bonds shall be executed in triplicate so that the Commissioner, the taxpayer, and the surety or the depositary may each have a copy.

Pending the completion of the liquidation, if there is a compliance with paragraphs (a), (b), and (c) of this section and § 29.112 (b) (6)-1 with respect to the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 113 (a) (15). (See § 29.113 (a) (15)-1.) However, if the transfer of the property is not completed within the 3-year period allowed by section 112 (b) (6) or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 112 (b) (6) or section 113 (a) (15) and the amount of any additional tax due upon such recomputation shall be promptly paid.

§ 29.112 (b) (6)-4 *Distributions in liquidation as affecting minority interests.* Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 112 (b) (6), since it does not apply to that part of distributions in liquidations received by minority shareholders.

§ 29.112 (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 properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement as to its ownership of all classes of stock of the liquidating corporation (showing as to each class the number of shares and percentage owned and the voting power of each share) as of the date of the adoption of the plan of liquidation, and at all times since, to and including the date of the distribution in liquidation, and the cost or other basis of such stock.

[Sec. 112. Recognition of gain or loss—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

[(b) *Exchanges solely in kind*—]

(8)[1] *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, 1939, 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).

§ 29.112 (b) (9)-1 *Nonrecognition of loss upon transfer of property of railroad corporation.* 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.

[1] There is no paragraph (7).

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.

[Sec. 112. Recognition of gain or loss—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(c) *Gain from exchanges not solely in kind.* (1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

§ 29.112 (c)-1 *Receipt of other property or money in tax-free exchange not connected with corporate reorganization.* If in any transaction in which (a) property held for investment or productive use in trade or business is exchanged for property of like kind to be held either for productive use or for investment; or (b) common stock is exchanged for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization; or (c) property is transferred by one or more persons to a corporation for its stock or securities, within the meaning of section 112 (b) (5), there is received by the taxpayer other property (in addition to property permitted to be received without recognition of gain) or money, then

(1) The gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example. A, who is not a dealer in real estate, in 1942 exchanges real estate, which he purchased (for investment) in 1921 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and he receives in addition $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

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), (2), and (3). As to the proper treatment of such consideration for the purposes of so much of section 112 (c) as relates to section 112 (b) (5), see section 112 (k) and § 29.112 (k)-1.

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.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see § 29.112 (g)-4.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(d) *Same—gain of corporation.* If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(e) *Loss from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

§ 29.112 (e)-1 *Nonrecognition of loss.* The Internal Revenue Code provides that in no event shall a loss be recognized from a tax-free exchange of property under section 112 (b) (1) to (5), inclusive, notwithstanding the fact that there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss.

As to the 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).

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(f) *Involuntary conversions.* If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily and involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

§ 29.112 (f)-1 *Reinvestment of proceeds of involuntary conversion.* Upon the involuntary conversion of property described in section 112 (f), no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 112 (f), the gain, if any, is recognized to the extent of the money which is not so expended. For example, a vessel purchased by A in 1939 for $100,000 is destroyed by an enemy submarine in 1942, and A receives in 1942 insurance in the amount of $100,000. This money is not expended in the manner provided in section 112 (f), but there is no gain since the insurance does not exceed the basis (disregarding, for the purposes of this example, the adjustment for depreciation). In 1947, A receives an award of $200,000 from the Government on account of the destruction of the vessel. He expends this amount in the manner provided in section 112 (f). The gain in 1947 upon the receipt of this award is recognized to the extent of $100,000, the amount of the money received in 1942 which was not expended in the manner provided in section 112 (f). The loss sustained as a result of an involuntary conversion described in section 112 (f) is recognized. The expenditure in the manner provided in section 112 (f) of money received upon an involuntary conversion is not necessary for the transaction to be considered completed for the purpose of determining such loss.

In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

The provisions of section 112 (f) are applicable to property used for residential or farming purposes.

The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

There is no investment in property similar in character and devoted to a similar use if:

(a) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(b) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(c) The owner of a requisitioned tug uses the proceeds to buy barges.

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

§ 29.112 (f)-2 *Replacement funds.* In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately (for example, because of the taxpayer's inability to obtain priorities, or because of other wartime restrictions), he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Act of 1926, as amended, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against

him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(g) *Definition of reorganization.* As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (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 corporation, 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.

§ 29.112 (g)-1 *Purpose and scope of exception of reorganization exchanges*—(a) *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 (occuring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the 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.

(b) *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 the preceding paragraph of 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. 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.

§ 29.112 (g)-2 *Definition of terms.* The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

The words "statutory merger or consolidation" refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

In order to qualify as a "reorganization" under section 112 (g) (1) (B), the acquisition by the acquiring corporation of the required amount of the stock 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).

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.

A "recapitalization," and therefore a reorganization, takes place if, for example:

(a) 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;

(b) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(c) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

(d) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference

to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

The term "a party to a reorganization" includes, in addition to a corporation which performs the specific act constituting the reorganization as described and defined in section 112 (g) (1), only a corporation specified in section 112 (g) (2). Both corporations are parties to the reorganization if under statutory authority Corporation A is merged into Corporation B; and all three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporations C and D are consolidated into Corporation E. Both corporations are parties to the reorganization if it consists of the transfer by Corporations F and G of part of the assets of Corporation F in exchange for all of the capital stock of Corporation G. Only Corporations H and J are parties to the reorganization if it consists of the acquisition by Corporation H in exchange solely for all or a part of its voting stock of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of Corporation J, even though such acquition by Corporation H is from Corporation K.

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in 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 effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

As used in section 112, as well as in other provisions of the 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.

§ 29.112 (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 § 29.112 (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.

§ 29.112 (g)-4 *Exchanges in reorganization for stock or securities and other property or money.* If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(a) 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

(b) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e).

Example. A, in connection with a reorganization, in 1942, 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.

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized.

Example. The X Corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X Corporation in 1942 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 1929 paid $100, receives a share of stock in the Y Corporation worth $100 and the sum of $50 in cash in addition. A gain of $50 is recognized to A.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to the reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, as provided in section 112 (d) (1), if the other property or money received by the Corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corpooration 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)).

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) and the regulations prescribed thereunder. For the proper treatment of an assumption of liabilities under so much of section 112 (c) as relates to section 112 (b) (3), see § 29.112 (c)-1.

§ 29.112 (g)-5 *Receipt of stock or securities in reorganization without surrender of stock by shareholder.* Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, by or on behalf of a corporation a party to a reorganization, of its stock or securities (other than its own stock, which is not taxable as a dividend under section 115 (f)) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (1) the earnings or profits of the corporation of the taxable year com-

puted without regard to prior years and (2) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings or profits shall be applied against and used to reduce the basis provided in section 113 of the stock in respect to 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 § 29.111-1.)

§ 29.112 (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.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(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

§ 29.112 (h)-1 *Control of corporation.* Section 112 (h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112 (b) (5) and section 112 (g) (1). It is provided specifically that this definition is limited to the meaning of the term "control" as that term is used in section 112.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rev. Act 1942.]

(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.

§ 29.112 (i)-1 *Reorganization with, or transfer of property to or from, a foreign corporation.* 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. The term "Federal income taxes" includes (1) the excess-profits tax on the net income of a corporation referred to in section 106 of the Revenue Act of 1935, section 402 of the Revenue Act of 1936, and section 602 of the Revenue Act of 1938, (2) the declared value excess-profits tax referred to in section 600 of the Internal Revenue Code, and (3) the excess profits tax imposed by subchapter E of chapter 2 of the Code.

Whether any of the exchanges or distributions referred to in section 112 (i), involving a foreign corporation, is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, is a question to be determined from the facts and circumstances of each particular case. In any such case if a taxpayer desires to establish that the exchange or distribution is not in pursuance of such a plan, a statement under oath of the facts relating to the plan under which the exchange or distribution is to be made, together with a copy of the plan, shall be forwarded to the Commissioner of Internal Revenue, Washington, D. C., for a ruling. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If the Commissioner determines that the exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, the taxpayer should retain a copy of the Commissioner's letter as authority for treating the foreign corporation as a corporation in determining the extent to which gain is recognized from the exchange or distribution. If the reorganization or the transfer is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

[SEC. 112. RECOGNITION OF GAIN OR LOSS—as amended by sec. 213 (a) (b) (c), Rev. Act 1939; secs. 142 (a), 151 (d) (e), Rec. Act 1942.]

(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) or (5) 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) or (5); 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 burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

§ 29.112 (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. Subject to the exceptions and limitations specified in paragraph (b)

of this section, section 112 (k) provides, however, 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) or (5); 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) or (5) consists of an assumption of liabilities, the transaction, if otherwise qualified, shall be deemed to be within the provisions of section 112 (b) (4) or (5).

The application of this paragraph 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 that extent.

(b) *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.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS [as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942].

(a) *Basis (unadjusted) of property.* The basis of property shall be the cost of such property; except that—

§ 29.113 (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 §§ 29.113 (a)-2 to 29.113 (a) (21)-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, see sections 510 and 511 of the Merchant Marine Act of 1936, as amended. For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 127 (d).

§ 29.113 (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) (21), inclusive.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (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 §§ 29.22 (c)-1 to 29.22 (d)-7, inclusive.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (2)-1 *Property transmitted by gift after December 31, 1920.*—(a) *Property included.* Section 113 (a) (2) applies to all property acquired after December 31, 1920, by gift. It does not apply:

(1) To property acquired by devise or bequest (see section 113 (a) (5)); or

(2) To property acquired by an instrument which, under section 113 (a) (5), is to be treated as though it were a will.

Section 113 (a) (2) applies to all gifts of whatever description, 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.* 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.

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 § 29.113 (a) (5)-1.

The time of the gift is the time when the gift is consummated. Delivery, actual or constructive, is requisite to a gift. In determining the time of the gift, the passing of title by the donor is not decisive; the time when the donor relinquishes substantial dominion over the property is decisive.

(c) *Fair market value.* For the purposes of this 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 if March 1, 1913.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (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) *Reimbursements 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (4)-1 *Gift or transfer in trust prior to January 1, 1921—*(a) *Property included.* Section 113 (a) (4) applies to all property acquired before January 1, 1921, by gift or transfer in trust. It does not apply to property acquired by a devise or bequest; or by an instrument which, under section 113 (a) (5), is to be treated as though it were a will.

(b) *Basis.* The basis is the fair market value of such property at the time of the gift or at the time of the transfer in trust. Such fair market value is to be ascertained in the manner prescribed in paragraph (c) of § 29.113 (a) (2)-1, or by equivalent methods.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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. [Sec. 144 (b), Rev. Act 1942, provides that the last sentence of section 113 (a) (5) shall be applicable only with respect to the property includible in the gross estate of a decedent dying after October 21, 1942, the date of the enactment of the Revenue Act of 1942.]

§ 29.113 (a) (5)-1 *Basis of property acquired by bequest, devise, or inheritance—*(a) *Property included.* Section 113 (a) (5) applies:

(1) To all property passing from a decedent by his will or under the law governing the descent and distribution of property of decedents; and

(2) To property passing under an instrument which, under section 113 (a) (5), is treated as though it were a will, but applies to such property only at the times and to the extent prescribed in section 113 (a) (5).

(b) *Basis.* Section 113 (a) (5) provides 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.

(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 paragraph (b) (3) 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.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 113 (a) (14).

If the property is an investment by the fiduciary under a will (as, for example, in the case of a sale by a fiduciary under a will of property transmitted from the decedent, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the fair market value at the time when the decedent died.

(e) *Adjustments to basis.* In the hands of every person who acquires the property of a decedent (or any estate or interest therein) by bequest, or devise, or inheritance, the basis of the property is always the same,

(1) Whether such person be the executor or administrator, the heir, the legatee, the devisee, the trustee of a trust created by the will, or any beneficiary of such trust, and whatever the nature of any such person's interest or estate may be;

(2) Whether during or after administration and settlement of the estate of the decedent, during or after the term of any trust under the will, or before or after the distribution by the executor or administrator, or the trustee.

Adjustments to basis required by section 113 (b) are made in accordance with the same principles. Thus, the deductions for depreciation and for depletion allowed or allowable, under section 23 (l) and section 23 (m), to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property in the hands not only of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under section 23 (l) and section 23 (m), both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 24 (a). Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable.

The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(a) *Basis (unadjusted) of property.* The basis of property shall be the cost of such property; except that—]

(6) *Tax-free exchanges generally.* If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis (except as provided in 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) 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.

§ 29.113 (a) (6)-1 *Property acquired upon a tax-free exchange.* In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112 (b), if no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

If, in an exchange, after February 28, 1913, of properties of the type indicated in section 112 (b), gain to the taxpayer was recognized under the provisions of section 112 (c) or (d) or a similar provision of a prior Revenue Act, on account of the receipt of money in addition in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. For example: A purchased a share of stock in the X Corporation in 1927 for $100. Pursuant to a plan of reorganization, A in 1942 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). As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the share of stock in the Y Corporation is $90; that is, the basis of the share in the X Corporation ($100) less the amount of money received by A ($30) plus the amount of gain recognized on the exchange ($20).

If, upon an exchange of properties of the type described in section 112(b), there was received by the taxpayer in addition other property (not permitted to be received without the recognition of gain) and money, and gain from the transaction was recognized as required under section 112 (c) or (d) or a similar provision of a prior Revenue Act, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

Example. A purchased a share of stock in the X Corporation in 1925 for $100. Upon a reorganization of the X Corporation in 1942, 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). As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the property received in exchange is the basis of the old stock ($100) decreased in the amount of money received ($20) and increased in the amount of gain that was recognized ($30), which results in a basis for the property received of $100. This basis of $110 is apportioned between the Treasury bond and the share of stock, the basis of the Treasury bond being its fair market value at the date of the exchange, $50, and of the share of stock, the remainder, $60.

Section 112 (e) and similar provisions of prior Revenue Acts provide that no loss may be recognized on an exchange of properties of a type described in section 112 (b), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties received by the taxpayer (other than money) is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to such other property (not permitted to be exchanged tax free) an amount of such basis equivalent to the fair market value of such other property at the date of the exchange.

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).

§ 29.113 (a) (6)-2 *Treatment of assumption of liabilities.* 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.

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, 1942, 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, 1942, 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

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (7)-1 *Property acquired by corporation in reorganization after December 31, 1917.* Section 113 (a) (7) sets forth the conditions under which the basis of property acquired by a corporation after December 31, 1917, in connection with a reorganization as defined in section 112 is the same as it would be in the hands of the transferor, increased or decreased as therein provided in the amount of gain or loss recognized to the transferor under the applicable revenue law. In the case of property so acquired in a taxable year beginning prior to January 1, 1936, such basis is applicable only if immediately after the transfer there remained in the same persons or any of them an interest or control in such property of 50 percent or more. In the case, however, of property so acquired in a taxable year beginning after December 31, 1935, section 113 (a) (7) is applicable irrespective of the extent of the interest or amount of control in such property remaining, immediately after the transfer, in the hands of the same persons or any of them.

The application of the provisions of section 113 (a) (7) (A) may be illustrated by the following examples:

Example (1). In 1925 the X Corporation caused the organization of the Y Corporation and transferred to the Y Corporation, in exchange for all the capital stock of that corporation, property which it had previously purchased for $10,000. The basis of the property in the hands of the Y Corporation is $10,000.

Example (2). In 1925 the M Corporation exchanged 10 percent of its voting stock for all the property of the N Corporation which had a basis of $10,000 in the hands of the N Corporation. The basis of the property in the hands of the M Corporation is cost thereof to it at the time of the transfer, that is, the fair market value of the M stock exchanged for the property.

Section 113 (a) (7) does not apply if, irrespective of when acquired, the property consists of stock or securities in a corporation a party to a reorganization as defined in section 112, unless such stock or securities are acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. The application of the last sentence of section 113 (a) (7) to a case where such stock or securities are acquired by the issuance of stock or securities of the transferee may be illustrated as follows:

Example (3). The Y Corporation owns all of the stock of the X Corporation, which stock it acquired in 1942 by the issuance of all of its own voting stock to the individual shareholders of the X Corporation. The stock of the X Corporation was acquired by the individuals in 1924 for $200,000 in cash. The stock of the Y Corporation had a fair market value of $1,000,000 at the time it was exchanged in 1942 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 1942 was also $1,000,000. The basis to the Y Corporation of the stock of the X Corporation is the basis which such stock would have had in the hands of the individuals from which it was acquired by the Y Corporation, that is, $200,000.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (8)-1 *Property acquired by a corporation after December 31, 1920.* The acquisition of property by a corporation after December 31, 1917, by the issuance of its stock or securities may not fall within the provisions of 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.

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113 (a) (2).

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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), 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.

§ 29.113 (a) (9)-1 *Property acquired as a result of an involuntary conversion.* The provisions of section 113 (a) (9) may be illustrated by the following example:

Example. A vessel purchased by A in 1927 for $100,000 is destroyed in 1942 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (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 1927, which he sold January 15, 1942, for $80. On February 1, 1942, 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 1927, which he sold January 15, 1942, for $80. On February 1, 1942, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 118. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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 recog-

nized. 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.

§ 29.113 (a) (11)-1 *Basis of property acquired during affiliation.* The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this 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.

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under Regulations 75, Regulations 78, Regulations 89, Part 4, Part 15 or Part 23 of this chapter, or subsequent regulations relating to consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under Regulations 75, Regulations 78, Regulations 89, Part 4, Part 15 or Part 23 of this chapter, or subsequent regulations relating to consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1941 and makes a separate return for the taxable year 1942 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1942 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939: sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (12)-1 *Basis of property established by Revenue Act of 1932.* Section 113 (a) (1) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113 (a) (6), (7), or (9) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

If, after December 31, 1923, and in any taxable year beginning prior to January 1, 1934, in pursuance of a plan of reorganization and without the surrender of his stock, there was distributed to a shareholder in a corporation a party to the reorganization stock or securities of a corporation a party to the reorganization, then as is provided in section 113 (a) (9) of the Revenue Act of 1932, the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the new shares or securties shall be determined in accordance with the following rules:

(a) 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.

(b) 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.

(c) 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 § 29.22 (a)-8), and any sale of the stock or securities distributed in reorganization will be resumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

(d) If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the stock or securities distributed in reorganization cannot be identified as having been distributed in respect of any particular lot of such stock, then any sale of the stock or securities distributed in reorganization will be presumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

If in any taxable year beginning after December 31, 1941, 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 § 29.112 (g)-5.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941;

secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (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.

§ 29.113 (a) (13)-2 *Readjustment of partnership interests.* When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost or other basis as hereinbefore provided and the value of such interest as of such date, plus the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in § 29.111-1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (14)-1 *Property acquired prior to March 1, 1913.* The basis as of March 1, 1913, for determining gain in the case of property acquired prior to that date, is the basis otherwise provided for such property under section 113 (a), adjusted for the period prior to March 1, 1913, or the fair market value of the property as of March 1, 1913, whichever is higher.

The basis as of March 1, 1913, for determining loss in the case of property acquired prior to that date is the cost or other basis provided for such property under section 113 (a) adjusted as required by section 113 (b), but without reference to the fair market value of the property as of March 1, 1913.

Example. A, who makes his returns upon the calendar year basis, in 1908 purchased property for $100,000. Assuming, for the purposes of this example, that there are no additions and betterments to be taken into account, the depreciation sustained on the property prior to March 1, 1913, was $10,000, so that the original cost adjusted as of March 1, 1913, for depreciation sustained prior to that date was $90,000. As of that date the fair market value of the property was $94,000. (*a*) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1942, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If it be assumed that the amount of depreciation deductions allowed (not less than the amount allowable) after February 28, 1913, to the year 1942 is in the aggregate sum of $43,240, the adjusted basis for determining gain in 1942 ($94,000 less $43,240) is $50,760. (*b*) For the purpose of determining a loss from the sale or other disposition of such property in 1942, the basis of the property is the cost of the property, without reference to the fair market value as of March 1, 1913, adjusted for depreciation before March 1, 1913, and after February 28, 1913. The amount of depreciation sustained prior to March 1, 1913, in this example is $10,000, and if the amount of depreciation to be accounted for after February 28, 1913, is assumed to be $43,240, the aggregate amount of depreciation for which adjustment of such cost must be made is $53,240. The adjusted basis for determining the loss in 1942 ($100,000 less $53,240) is $46,760.

What the fair market value of property was on March 1, 1913, is a question of fact to be established by competent evidence. In determining the fair market value of stock in a corporation, due regard shall be given to the fair market value of the corporate assets on such date. In the case of property traded in on public exchanges, actual sales at or about the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced sale price or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time, but such value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in every case.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (a) (15)-1 *Basis of property received by a corporation in complete liquidation of another corporation.* 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).

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:

(a) Such property was received in a liquidation which was completed before June 23, 1936;

(b) 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;

(c) 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

(d) The recipient corporation (within 180 days after the enactment of the Revenue Act of 1938) under regulations prescribed under section 808 of the Revenue Act of 1938, (Treasury Decision 4815)[1] elected to have such basis apply to such property.

If such an election was made, the basis of such property received in liquidation shall be the cost or other basis (adjusted as provided in section 113) of the stock of the liquidating corporation surrendered in exchange for the property, decreased in the amount of money received and increased in the amount of gain or decreased in the amount of loss to the recipient corporation that was recognized upon the liquidation under the Revenue Act of 1936. If such property consists of more than one class of property the basis shall be allocated among the several properties (other than money) received, in the proportion that the fair market value of each such property as of the date of distribution bears to the fair market value of all such properties on that date.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

§ 29.113 (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 begining prior to January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113 (a) (6), (7), or (8) of that Act, then for the purposes of the 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 prior to January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112 (b) (5) of the 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.

[1] 26 CFR 3.113 (a) (15)-1.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.

(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 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.

§ 29.113 (a) (18)-1 *Basis of property received in certain corporate liquidations*—(a) *Property included.* Section 113 (a) (18) applies only to property (other than money) acquired (1) by a qualified electing shareholder, (2) upon a distribution in complete liquidation of a domestic corporation pursuant to a plan of liquidation adopted after May 28, 1938, in accordance with which the distribution is in complete cancellation or redemption of all the stock and the transfer of all the property in the liquidation occurs within the month of December 1938, and (3) in cancellation or redemption of only those shares of stock which were owned by such qualified electing shareholder on the date of the adoption of the plan of liquidation and on which he realizes gain. It applies to all the property, except money, so acquired, though such property may consist in whole or in part of stock or securities acquired by the liquidating corporation after April 9, 1938.

(b) *Basis.* The basis of such property so acquired is the same as the basis of the shares of stock, in cancellation or redemption of which such property was received, with proper adjustments to the date of acquisition, decreased in the amount of such shares' ratable share of any money received in cancellation or redemption of shares of the same class, and increased in the amount of gain recognized under the provisions of section 112 (b) (7) of the Revenue Act of 1938. If such property consists of more than one class of property, the basis shall be allocated among the several properties (other than money) acquired in the proportion that the fair market value of each such property as of the date of acquisition bears to the fair market value of all such properties on that date. The application of this subsection may be illustrated by the following example:

Example. The X Corporation distributed all its property in complete liquidation during the month of December 1938, pursuant to the provisions of section 112 (b) (7) of the Revenue Act of 1938. A, an individual and a qualified electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him on the date of the adoption of the plan of liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after April 9, 1938) with a fair market value of $12,000, and stock acquired by the liquidating corporation after April 9, 1938, with a fair market value of $4,000. The basis of the shares owned by A was $100 per share, or $10,000. A's ratable share of the earnings and profits of the X Corporation accumulated after February 28, 1913 (computed as provided in section 112 (b) (7) of the Revenue Act of 1938), was $2,500. His gain is $7,000, but under section 112 (b) (7) of the Revenue Act of 1938 only $5,000 of this gain is recognized, $2,500 thereof being taxed as a dividend. The basis of all the property other than money received by A is $14,000, computed as follows:

Adjusted basis of stock canceled or redeemed	$10,000
Less money received	1,000
Remainder	9,000
Plus gain recognized	5,000
Basis of property acquired	14,000

This basis will be apportioned among the classes of property (other than money) received as follows: 12,000/16,000 of $14,000, or $10,500, to the property other than stock; 4,000/16,000 of $14,000, or $3,500, to the stock.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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 [known as The Tax Court of the United States], 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.

§ 29.113 (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 § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 29.113 (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 § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 29.22 (a)-8.

(c) *Stock rights acquired before January 1, 1925.* In the case of stock in respect of which were acquired prior to 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 § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in article 39 of Regulations 65.

§ 29.113 (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 prior to January 1, 1939, the general rules for ascertaining the basis for determining gain or loss set forth in paragraphs (b) and (c) of § 29.113 (a) (19)-1, and in § 29.22 (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 prior to January 1, 1936, the general rules for ascertaining the basis for determining gain or loss set forth in § 29.113 (a) (19)-1, and in §§ 29.113 (a) (12)-1, 29.22 (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 § 29.113 (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 prior to 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 on or before September 26, 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act, 1939; sec. 1, Pub Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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, 1939, 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[1] 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).

§ 29.113 (a) (20)-1 *Property acquired by railroad corporation in a receivership or bankruptcy proceeding.* 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

[1] Evidently intended to be "of".

court having jurisdiction of the proceeding.

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).

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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).

§ 29.113 (a) (21)-1 *Property acquired by electric railway corporation in bankruptcy proceeding.* Subject to the limitations and conditions set forth in section 113 (a) (21), if the reorganization under section 77B of the National Bankruptcy Act, as amended, 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 Chapter X of the National Bankruptcy Act, as amended, relating to the adjustment of basis by reason of the cancellation or reduction of indebtedness in a bankruptcy 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

(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 for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(D) in the case of stock (to the extent not provided for in the foregoing subparagraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918, 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.

§ 29.113 (b) (1)-1 *Adjusted basis; general rule.* The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113 (a) (1) to (21), inclusive, the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. In the case of mines and oil or gas wells the following shall not be considered as items properly chargeable to capital account: (1) Expenditures made in the taxable year 1932 or subsequent taxable years which are allowable under article 235 or 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,[1] article 23 (m)-15 or 23 (m)-16 of Regulations 101,[1] §§ 19.23 (m)-15 or 19.23 (m)-16 of Regulations 103, and §§ 29.23 (m)-15 or 29.23 (m)-16 of these regulations as deductions in computing net income; (2) expenditures made in taxable years prior to 1932 which were allowed, or which may hereafter be allowed, as deductions in computing the net income of the taxpayer for such taxable years.

Example. A, who makes his returns on the calendar year basis, purchased property in 1933 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 1942 for $20,000, the amount of his gain will be $4,000. As to the amount of such gain to be taken into account in computing net income, see section 117.

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, as to which under these regulations there is an election to treat either as chargeable to capital account or as an allowable deduction in the manner provided in § 29.24-5 (c) but for which there have been taken no deductions by the taxpayer in determining net income for the taxable year, or a prior taxable year, are properly chargeable to capital account. (See § 29.24-5.) The term "taxes" for this purpose includes duties and excise taxes (see § 29.23 (c)-2), but does not include income taxes.

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolence, amortization, and depletion to the extent such deductions have in respect to any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made

[1] §§ 3.23 (m)-15, 3.23 (m)-16, 9.23 (m)-15, 9.23 (m)-16 of this chapter.

on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. For example, the case of Corporation A discloses the following facts as of January 1, 1942:

Year	Allowed	Allowable	Allowed, but not less than amount allowable
1935	$6,000	$5,000	$6,000
1936	7,000	6,500	7,000
1937	6,500	6,500	6,500
1938	6,500	6,000	6,500
1939	5,000	6,000	6,000
1940	4,500	6,000	6,000
1941	4,000	6,000	6,000
	39,500	42,000	44,000

The depreciation allowed but not less than the amount allowable in this example as of January 1, 1942, is $44,000, and the cost or other basis of the property is to be adjusted by that amount. The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114 (b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, 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 prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depletion sustained in respect of any period prior to March 1, 1913.

In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921).

Example. A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated prior to March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1942 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition. But see section 117.

In the case of the stock of United States shareholders in a foreign personal holding company the cost or other basis must be adjusted also to the extent provided in section 337 (f).

Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Internal Revenue Code. For adjustment to basis of bonds on account of amortizable bond premium, see §§ 29.125-1 to 29.125-9, inclusive.

§ 29.113 (b) (1)-2 *Adjusted basis; cancellation of indebtedness.* In addition to the adjustments provided in section 113 (b) (1) and § 29.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under sections 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B or under Chapter X, XI, or XII of the Bankruptcy Act of 1898, as amended. Such further adjustment shall be made in the following manner and order:

(a) 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;

(b) 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;

(c) 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 (a) and (b) 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 (a) and (b) 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 (a) and (b)) of each such unit of property bears to the sum of the adjusted bases (after adjustment under (a) and (b)) of all the property of the debtor other than inventory and notes and accounts receivable;

(d) 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 (a), (b), and (c) shall next be applied to reduce the cost or other basis of any units of property covered by (a), (b), and (c) which have a remaining basis (after adjustment under (a), (b), and (c)) 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 (a), (b), and (c) 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

(e) 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 (a), (b), (c), and (d) 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.

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.

Any determination of value in a proceeding under the Bankruptcy Act, as amended, shall not constitute a determination of fair market value for the purposes of this section.

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.

§ 29.113 (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 § 29.113 (b) (1)-2. Variations from such rule may, for example, involve adjusting the basis of any part of the taxpayer's property 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.]

(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.

§ 29.113 (b) (2)-1 *Substituted basis.* Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2), the adjustments indicated in § 29.113 (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 §§ 29.113 (b) (1)-2, 29.113 (b) (3)-1, and 29.113 (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.

Example. A, who makes his returns upon the calendar year basis, in 1927 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 1942, 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.

[SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 233 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 143 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

[(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.]

(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 23 (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.

§ 29.113 (b) (3)-1 *Adjusted basis; discharge of corporate indebtedness; general rule.* In addition to the adjustments provided in section 113 (b) (1) and § 29.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been 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 adjustment shall, except as otherwise provided in § 29.113 (b) (3)-2, be made in the following manner and order:

(a) 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;

(b) 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;

(c) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under (a) and (b) 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 (a) and (b)) 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

(d) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under (a), (b), and (c) 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.

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.

Example (1). On January 1, 1942, the N Corporation owned an office building, which it sold in March 1942. In June 1942 it purchased a factory building. In October 1942 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 1942. (But see § 29.113 (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 1942 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 A bonds, the total poration 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).

§ 29.113 (b) (3)-2 *Adjusted basis; discharge of corporate indebtedness; special cases.* Section 29.113 (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 § 29.113 (b) (3)-1 upon a proper showing to the satisfaction of the Commissioner. 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.

A request for variations from the general rule prescribed in § 29.113 (b) (3)-1 should be filed by the taxpayer with its return for the taxable year in which the discharge of indebtedness has occurred. 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 § 29.113 (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.

[SEC. 113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS—as amended by secs. 213 (d), 214 (a), 215 (b), 223 (b), Rev. Act 1939; sec. 1, Pub. Law 18, approved March 17, 1941; secs. 115 (b), 126 (c), 130 (b), 142 (b) (c), 143 (a) (b), 144 (a), 171 (h), Rev. Act 1942.]

(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 excludible 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.

§ 29.113 (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 prior to 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 from 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. In 1942 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, both years 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.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION [as amended by sec. 145, Rev. Act 1942].

(a) *Basis for depreciation.* The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for depletion*—(1) *General rule.* The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

(2) *Discovery value in case of mines.* In the case of mines (other than metal, coal, fluorspar, ball and sagger clay, rock asphalt, or sulphur mines) discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance under section 23 (m) based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(3) *Percentage depletion for oil and gas wells.* In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(4) *Percentage depletion for coal, fluorspar, ball and sagger clay, rock asphalt, and metal mines and sulphur.* The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, fluorspar, ball and sagger clay or rock asphalt mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, 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.

§ 29.114-1 *Basis for allowance of depreciation and depletion.* The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in § 29.23 (m)-3, relating to depletion based on discovery value, in § 29.23 (m)-4, relating to percentage depletion in the case of oil and gas wells, and in § 29.23 (m)-5, relating to percentage depletion in the case of coal mines, metal mines, fluorspar mines, ball and sagger clay mines, or rock asphalt mines, and sulphur mines or deposits.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS [as amended by sec. 214 (b), Rev. Act 1939; sec. 501 (a), 2d Rev. Act, 1940; secs. 146 (a), 147, 166, 186 (a) (b), Rev. Act 1942].

(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. Such term also means any distribution to its shareholders, whether in money or in other property, made by 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.

(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).

(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.

(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.

(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.

(g) *Redemption of stock.* If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redempton or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on earnings and profits of distributions of stock.* The distribution (whether before January 1, 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.

(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 ap-

plicable 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 purposes of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purpose 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.

(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 (1) 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 (1) 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.

§ 29.115-1 *Dividends.* 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:

(a) Earnings or profits accumulated since February 28, 1913, or

(b) 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.

The term "dividend" also includes any distribution to shareholders (other than distributions under section 115 (c), relating to distributions in liquidation, section 115 (e), relating to distributions by personal service corporations, and section 115 (f), relating to stock dividends) made by a corporation which, for the taxable year in which such a distribution is made or for the taxable year in respect of which it 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. Such a distribution, if made on or after October 21, 1942, will constitute a taxable dividend even if not paid out of accumulated or current earnings or profits. For treatment of any distribution made prior to October 21, 1942, which is a dividend solely by reason of the last sentence of section 115 (a), see § 29.504-3.

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

The application of section 115 (a) may be illustrated by the following example:

Example. At the beginning of the calendar year 1942, 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, 1942, the corporation made quarterly distributions during the taxable year to its shareholders of $25,000 each. Each distribution is a taxable dividend in full, irrespective of the actual or the pro rata amount of the earnings or profits on hand at any of the dates of distribution, since the total distributions made during the year ($100,000) did not exceed the total earnings or profits of the year ($100,000).

§ 29.115-2 *Sources of distributions in general.* For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given first, to the earnings or profits of the taxable year; second, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; third, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See § 29.115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 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. The provisions of this section may be illustrated by the following example:

Example. At the beginning of the calendar year 1942, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1942 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made; $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year, as follows:

Distributions during 1942		Portion out of earnings or profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and prior to taxable year	Taxable amount of each distribution
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

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of chapter 1.

§ 29.115-3 *Earnings or profits.* In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, 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.

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 § 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion 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 (1) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost of March 1, 1913, value, whichever is higher, if acquired prior to 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. The provisions of this paragraph may be illustrated by the following example:

Example. Oil producing property which A had acquired in 1936 at a cost of $23,000 was transferred to the Y Corporation in December 1938, 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 1942 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 $23,000 established in the nontaxable exchange in 1938 regardless of the fair market value of the property or of the stock issued in exchange therefor.

A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year. However, in determining the earnings or profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings or profits accumulated since February 28, 1913, and prior to the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. And, if the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings or profits accumulated since the year of the loss to the extent of such earnings.

With respect to the effect on the earnings or profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and prior to August 6, 1917, out of earnings or profits accumulated prior to March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

§ 29.115-4 *Distributions other than a dividend.* Under section 115 (d), any distribution (including a distribution out of earnings or profits accumulated before March 1, 1913) other than:

(a) A dividend (see §§ 29.115-1 and 29.115-2),

(b) A distribution out of increase in value of property accrued prior to March 1, 1913 (see § 29.111-1),

(c) A distribution in partial or complete liquidation (see § 29.115-5), or

(d) A distribution which, under section 115 (f) (1), is not treated as a dividend (see § 29.115-7)

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 section are applicable to such distributions received by one corporation from another corporation.

Example. In 1942 the M Corporation purchased certain shares of stock in the O Corporation for $10,000. During that year the M Corporation received a distribution from the O Corporation of $2,000 paid out of earnings or profits of the O Corporation accumulated prior to March 1, 1913. This distribution must be applied by the M Corporation against the basis of its stock in the O Corporation reducing such basis to $8,000. The $2,000 does not constitute a part of the earnings or profits of the M Corporation. If the M Corporation subsequently sells the stock of the O Corporation for $9,000, it realizes a gain of $1,000, which constitutes a part of its earnings or profits for the year in which the stock is sold. If the distribution had amounted to $14,000, the gain of $4,000 would be taxable to the M Corporation and would have constituted a part of the earnings or profits of that corporation for the year in which the distribution was made.

§ 29.115-5 *Distributions in liquidation.* 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 § 29.111-1, 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 conditions and limitations provided in section 117.

The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not prorata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining taxability of subsequent distributions by the corporation. (See §§ 29.27 (g)-1 and 29.115-11.)

For the purposes of the last sentence of section 115 (c), a liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible).

For the purposes of this section the determination of whether a foreign cor-

poration 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.

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 1931 at a cost of $1,500, and the remainder of 10 shares in December 1941 at a cost of $2,900. He receives in April 1942 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1931, and $2,500 on the 10 shares acquired in December 1941. The gain of $1,000 on the shares acquired in 1931 should be included in A's gross income to the extent of 50 percent, or $500; the loss of $400 on the shares acquired in 1941 should be deducted in computing A's net income to the extent of 100 percent, or $400. (See 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 1933 for $1,700 and 10 shares of which were acquired in January 1942 for $1,120. In May 1942 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 1933, and $1,520 on the 10 shares acquired in January 1942. The loss of $180 on the shares acquired in 1933 should be deducted in computing A's net income to the extent of 100 percent, or $400. the gain of $400 on the shares acquired in January 1942 should be included in A's gross income to the extent of 100 percent, or $400. (See section 117.)

§ 29.115-6 *Distributions from depletion or depreciation reserves.* A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings or profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in § 29.111-1. 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 of 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 § 29.111-1.) No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed.

§ 29.115-7 *Stock dividends.* A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. 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.

§ 29.115-8 *Election of shareholders as to medium of payment.* If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (a) in money or any other property or (b) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the sixteenth amendment to the Constitution, then the entire distribution is a taxable dividend regardless of:

(1) Whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

(2) Whether the election is exercised or exercisable before or after the declaration of the distribution; or

(3) Whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other.

The term "any other property" as used in this section 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 § 29.115-7.)

§ 29.115-9 *Distribution in redemption or cancellation of stock taxable as a dividend.* If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

§ 29.115-10 *Dividends paid in property.* If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See § 29.42-3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

§ 29.115-11 *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.* If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(a) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the re-

organization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization:

(1) 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

(2) 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.

(b) 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.

(c) 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.

(d) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (a), (b), (c), or (d) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (a), (b), or (c) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this 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.

§ 29.115-12 *Effect on earnings and profits of gain or loss realized after February 28, 1913.* 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) prescribed 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 (1) 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 (2) 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 § 29.115-3). Under both (1) and (2) 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 section 115 (l) depending upon the basis to which the adjustments are to be made. If the application 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) will be subject to the adjustment thereto required by section 115 (m) (2). (See § 29.115-14.)

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extend 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 sections 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 non-recognized 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. The application of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation on January 1, 1942, owned stock in the Y Corporation which it had acquired from the Y Corporation in December 1941, 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, 1942, the X Corporation made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1941, 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, 1942, 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 § 29.115-14.

Example (3). On July 31, 1942, 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 on 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.

The third sentence of section 115 (l) provides for cases in which the adjustments, prescribed in section 113, to the basis indicated in paragraph (1) or (2) of the first sentence, as the case may be, of section 115 (l), differ from the adjustments to such basis proper for the purpose of determining earnings or profits.

The adjustments provided by the third sentence of section 115 (l) reflect the treatment provided by § 29.115-3 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. The effect of such third sentence 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 1942 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 §§ 29.115-3 and 29.115-6).

Example (2). If, in the preceding example, 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 base 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. Section 112 (c) (1), and 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.

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 § 29.115-11.

§ 29.115-13 *Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.* In order to determine 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 prior to 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. These principles may be illustrated by the following examples:

Example (1). The X Corporation in 1942 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 §§ 29.113 (a) (19)-1 and 29.113 (a) (12)-1. The earnings and profits of the Y Corporation are not increased by reason of the receipt of such stock dividend.

§ 29.115-14 *Adjustments to earnings and profits reflecting increase in value accrued prior to March 1, 1913.* 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.

Paragraph (1) of section 115 (m) 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. The effect of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation acquired nondepreciable property prior to 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 1942 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 1908 at a cost of $100,000. Assuming no additions or betterments, and that the depreciation sustained prior to 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 in 1942 it was sold for $60,000. 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 (not less than the amount allowable) after February 28, 1913, to the date of the sale in 1942 is the aggregate sum of $43,240, the adjusted basis for determining gain in 1942 ($94,000 less $43,240) is $50,760 and the gain would be $9,240 ($60,000 less $50,760). 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 $9,240. 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 $41,400 instead of $43,240 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $48,600 ($100,000 reduced by the sum of $10,000 and $41,400) would be $11,400 ($60,000 less $48,600). 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 $11,400. The difference of $2,160 ($11,400 minus $9,240) 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.

Paragraph (2) of section 115 (m) is an exception to the general rule in paragraph (1) of such section 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 paragraph (1) of section 115 (m), 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. The following examples will show the application of section 115 (m) (2):

Example (1). The Y Corporation acquired nondepreciable property prior to 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 1942 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 1942 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 1942 as the 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 prior to 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 1942 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 1942 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 1942 as the 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 the 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.

SEC. 116. EXCLUSIONS FROM GROSS INCOME [as amended by sec. 2, Public Salary Tax Act 1939, repealing subsection (b); secs. 148, 149, Rev. Act 1942].

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) *Foreign resident for entire taxable year.* In the case of an individual citizen of the United States, who establishes to the satisfaction of the Commissioner that he is a bona fide resident of a foreign country or countries during the 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 would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individuals shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection. [Under the provisions of sec. 148 (b), Rev. Act 1942, this paragraph is applicable with respect to taxable years beginning after December 31, 1942. The corresponding provisions applicable with respect to taxable years beginning in 1942 are as follows: "In the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection."]

(2) *Taxable year of change of residence to United States.* In the case of an individual citizen of the United States, who has been a bona fide resident of a foreign country or countries for a period of at least two years before the date on which he changes his residence from such country to the United States, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof), which are attributable to that part of such period of foreign residence before such date, if such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

(c) *Income of foreign governments.* The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States.

(d) *Income of States, municipalities, etc.* Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility—

(1) If by the terms of such contract the tax imposed by this 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 rates 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 imposition of 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 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 an employee of a foreign government or of the Commonwealth of the Philippines (including a consular or other officer, or a nondiplomatic representative) received as compensation for official services to such government 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 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 the foreign government, or the Commonwealth of the Philippines, whose employee is claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country 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, § 754).

§ 29.116-1 *Earned income from sources without the United States.* For taxable years beginning after December 31, 1942, there is excluded from gross income earned income in the case of an individual citizen of the United States provided the following conditions are met by the taxpayer claiming such exclusion from his gross income: (a) It is established to the satisfaction of the Commissioner that the taxpayer has been a bona fide resident of a foreign country or countries throughout the entire taxable year; (b) such income is from sources without the United States; (c) the income constitutes earned income as defined in section 25 (a) if received from sources within the United States; and (d) such income does not represent amounts paid by the United States or any agency or instrumentality thereof. Hence, a citizen of the United States taking up residence without the United States in the course of the taxable year is not entitled to such exemption for such taxable year. However, once bona fide residence in a foreign country or countries has been established, temporary absence therefrom in the United States on vacation or business trips will not necessarily deprive such individual 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 in general by the application of the principles of §§ 29.211-2, 29.211-3, 29.211-4, and 29.211-5 relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual.

For any taxable year beginning after December 31, 1941, in the case of an individual citizen of the United States, there shall be excluded from gross income earned income from sources without the United States derived during the period of his foreign residence if (1) such citizen was a bona fide resident of a foreign country or countries for at least two years prior to the date upon which he became a resident of the United States and ceased to be a resident of such foreign country or countries; (2) such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; and (3) such income does not represent amounts paid by the United States or any agency or instrumentality thereof. The application of this provision may be illustrated by the following example:

Example. A, a United States citizen making his return on a calendar year basis, has been a resident of X country for a period of four years ended June 30, 1942, upon which date he becomes a resident of the United States and ceases to be a resident of X country. Throughout the years 1940 and 1941, A had rendered personal services in the X country payment for which was not made until August 1942, at which time he was paid for such services the sum of $50,000. Such amount may be excluded from gross income of A for the calendar year 1942.

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.

§ 29.116-2 *Income of foreign governments, ambassadors, and consuls.* The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax.

All employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered in the United States to such foreign government, provided (1) the services are of a character similar to those performed by employees of the Government of the United States in such foreign country and (2) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country. Section 116 (h) (2) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Govern-

ment 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).) Subject to the same conditions, wages, fees, or salaries of an employee of the Commonwealth of the Philippines received as compensation for official services rendered to such commonwealth are exempt from Federal income tax subject to the same kind of certification by the Secretary of State to the Secretary of the Treasury. Such latter exemption does not apply to a citizen of the United States unless he is also a citizen of the Commonwealth of the Philippines. (See section 251.) Under the provisions of the tax convention between the United States and France, and without regard to any other provision of this section, compensation paid by France to French citizens for labor or personal services performed in the United States is exempt from Federal income tax. Similarly, under the provisions of the tax convention between the United States and Sweden, wages, salaries, and similar compensation and pensions paid by Sweden or by any political subdivision or territory or possession thereof to individuals (other than citizens of the United States) residing in the United States are also exempt from Federal income tax. Similarly, under the tax convention between the United States and Canada (effective January 1, 1941), wages, salaries, and similar compensation paid by Canada or by any agency or instrumentality thereof or by any of the political subdivisions or territories or possessions of Canada to citizens of Canada residing in the United States are also exempt from Federal income tax.

§ 29.116-3 *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 collector of internal revenue for the district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain:

(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) An affidavit made by or on behalf of the taxpayer, which affidavit shall state that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amount refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at 6 percent per annum from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(b) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpaper 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.

SEC. 117. CAPITAL GAINS AND LOSSES [as amended by secs. 212 (a) (b), 214 (c), Rev. Act 1939; sec. 115 (b), Rev. Act 1941; secs. 150 (a) (b) (c) (d), 151 (a) (b) (c), 152, Rev. Act 1942].

(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 stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), or 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, or real property used in the trade or business of the taxpayer;

(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 net income;

(3) *Short-term capital loss.* The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 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 net income;

(5) *Long-term capital loss.* The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 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.

(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.

(b) *Percentage taken into account.* In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

(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), and 500, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 25 per centum of such excess.

(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, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess.

(d) *Limitation on capital losses*—(1) *Corporations.* In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of 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[1] $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.

(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.* The amount of the net short-term capital loss of the last taxable year beginning in 1941 (computed without regard to amounts treated as short-term capital losses from the preceding taxable year), which is not in excess of the net income for such taxable year, shall, to the extent of the net short-term capital gain for the succeeding taxable year (computed without regard to this paragraph), be a short-term capital loss of such succeeding taxable year.

(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.

(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.

(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 the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this 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.

(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.

(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.

(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 and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (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.

§ 29.117-1 *Meaning of terms.* The term "capital assets" includes all classes of property not specifically excluded by section 117 (a) (1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23 (l) 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 subject to the percentage provisions of section 117 (b) and losses from such transactions are not subject to the limitations on losses provided in section 117 (d), except that under section 117 (j) the gains and

[1] So in original.

losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See § 29.117-7. 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) prior to its amendment by 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 limitations of section 117 (b), (c), and (d). The term "ordinary net income" as used in these regulations for the purpose of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

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 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 percentage provisions of section 117 (b) and losses from such transactions are not subject to the limitation on losses provided in section 117 (d). 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 § 29.42-7) 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.

Section 117 (a) (2) to (9), inclusive, defines "short-term capital gain," "short-term capital loss," "long-term capital gain," "long-term capital loss," "net short-term capital gain," "net short-term capital loss," "net long-term capital gain," and "net long-term capital loss." These terms are used in the subsequent subsections of section 117.

The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for 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).

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.

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). The percentage brackets of section 117 (b) have no application to corporations, corporate gains and losses being taken into account to the full extent, without regard to the length of time the capital assets are held (though because of the limitation in section 117 (d) such losses may not be deductible in full).

Section 117 (a) (10) defines "net capital gain." 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). For application of the term "net capital gain," in computing the capital loss carry-over under section 117(e), see § 29.117-2 (c).

Section 117 (a) (11) defines "net capital loss" to mean 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."

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 § 29.117-7 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.

§ 29.117-2 *Percentage of capital gain or loss taken into account; net loss carry-over*—(a) *General.* In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. For instance, if unimproved real estate purchased by an individual for $20,000 is a capital asset and is sold by him for $25,000 after having been held for more than six months, only 50 percent of the recognized gain ($5,000), or $2,500, shall be taken into account in computing net income; or if such property is sold for $14,000, only 50 percent of the recognized loss ($6,000), or $3,000, shall be so taken into account.

(b) *Limitation on capital losses.* 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, 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 net long-term capital loss of $4,000, of which $2,000 (50% of $4,000) is taken into account, the net loss of $2,000 is allowable only to the extent of $1,000, the remaining $1,000 being an unallowable deduction. If the taxpayer's ordinary net income, computed without capital gains and losses, had been $400 instead of $5,000, only $400 of the net loss of $2,000 would have been allowed, giving the taxpayer no taxable income and an unallowable capital loss of $1,600. (For disposition of the unallowable capital loss, see paragraph (c) of this section.) However, in the case of banks, 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 evidence of indebtedness issued by any corporation (including one 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) *Net capital loss carry-over.* 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 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.

The practical operation of the provisions of section 117 (e) (1) may be illustrated by the following example:

Example. For the taxable years 1942 to 1946, inclusive, a taxpayer 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:

	1942	1943	1944	1945	1946
Carry-over from prior years:					
From 1942		($50,000)	($29,500)	$(29,500)	
From 1944				(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	(20,500)		(10,000)	(6,000)	
Net long-term gain		25,000			
Net capital gain (computed without regard to the carry-overs)		20,500		36,000	
Net income (computed without regard to capital gains or losses)	500	500	500	1,000	
Net capital loss	(50,000)	None	(19,500)	None	

Net Capital Loss of 1942

The net capital loss is $50,000. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges, and (2) net income of $500. This amount may be carried forward in full to 1943. However, in 1943 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 1944 and 1945 since there was no net capital gain in 1944. In 1945 this $29,500 shall be 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).

Net Capital Loss of 1944

The net capital loss is $19,500. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges and (2) net income of $500. This amount may be carried forward in full to 1945. However, in 1945 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 1946.

§ 29.117-3 *Alternative tax in case of net long-term capital gain or loss.* 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, if and only if such alternative tax is less than the tax imposed by sections 11 and 12. For any such taxable year this alternative tax is the sum of (1) a partial tax, computed at the rates provided by sections 11 and 12, on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) 50 percent of such excess.

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, 14, 15, 204, 207 (a) (1) or (3), and 500, if and only if such alternative tax is less than the tax imposed by such sections. For any such taxable year this alternative tax is the sum of (1) a partial tax computed at the rates provided by sections 13, 14, 15, 204, 207 (a) (1) or (3), 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 of such excess.

The following example will illustrate the practical operation of the provisions of this section in the case of a taxpayer other than a corporation:

Example. Suppose that A, an individual, has for the calendar year 1942 an ordinary net income of $100,000, none of which consists of interest on the obligations of the United States or its instrumentalities. He is entitled to a personal exemption of $1,200 and to no credit for dependents, and his earned net income is $3,000. He realizes in that year a gain of $100,000 on a capital asset held for 19 months and sustained a loss of $20,000 on a capital asset held for 5 months. Since the alternative tax is less than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $79,126. The tax is computed as follows:

Tax Under Sections 11 and 12

Ordinary net income		$100,000.00
Net long-term capital gain: (50 percent of $100,000)	$50,000.00	
Net short-term capital loss: (100 percent of $20,000)	20,000.00	
Excess of the net long-term capital gain over the net short-term capital loss		$30,000.00
Total net income		130,000.00
Less: Credit for personal exemption		1,200.00
Surtax net income		128,800.00
Less earned income credit (10 percent of $3,000)		300.00
Income subject to normal tax		128,500.00
Normal tax (6 percent of $128,500)		7,710.00
Surtax on $128,800		81,892.00
Total tax		89,602.00

Alternative Tax Under Section 117 (c) (2)

Net income	$130,000.00
Less: Excess of the net long-term capital gain over the net short-term capital loss	30,000.00
Ordinary net income	100,000.00
Less credit for personal exemption	1,200.00
Surtax net income	98,800.00
Less earned income credit (10 percent of $3,000)	300.00
Income subject to normal tax	98,500.00
Normal tax (6 percent of $98,500)	5,910.00
Surtax on $98,800	58,216.00
Partial tax under sections 11 and 12 on $100,000	64,126.00
Plus 50 percent of $30,000	15,000.00
Total alternative tax	79,126.00

§ 29.117-4 *Determination of period for which capital assets are held.* Under section 117 (h) if property is acquired in certain transactions described in sections 112, 113, 118, and 371 (c), the period for which such property is considered to have been held by the taxpayer is not computed from the date such property was acquired by the taxpayer but from a prior date. For instance: In the case of stock or securities in a corporation a party to a reorganization received pursuant to a plan of reorganization in exchange solely for stock or securities in another corporation a party to the reorganization, the period for which the stock or securities exchanged were held by the taxpayer must be included in the period for which the stock or securities received on the exchange were held by the taxpayer. In the case of property acquired after December 31, 1920, by gift (if under the provisions of section 113, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor), the period for which the property was held by the donor must be included in the period for which the property was held by the taxpayer. In the case of stock or securities the acquisition of which resulted in the nondeductibility (under section 118 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.

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.

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.

§ 29.117-5 *Application of section 117 in the case of husband and wife*—(a) *Taxable year beginning in 1942.* If a husband and wife making a joint return for the first taxable year beginning in 1942, did not make a joint return for the preceding taxable year, the individual net short-term capital loss of each spouse for the preceding taxable year (in an amount not in excess of the individual net income of such spouse for such year) shall be totaled and such total shall be a short-term capital loss for such first taxable year beginning in 1942, to the extent of the excess of short-term capital gains over short-term capital losses for such year. If, however, a joint return was made for such preceding taxable year, a net short-term capital loss as shown by such joint return (in an amount not in excess of the aggregate net income for such year as shown by such return) shall be a short-term capital loss for the first taxable year beginning in 1942, to the extent of the excess of short-term capital gains over the short-term capital losses for such year. If a husband and wife making separate returns for the first taxable year beginning in 1942, made a joint return for the preceding taxable year, a net short-term capital loss shown by such joint return shall be allocated to the spouses on the basis of their individual net short-term capital losses for such preceding taxable year, and the net short-term capital loss allocated to each spouse (in an amount not in excess of the portion of the aggregate net income shown by such joint return attributable to such spouse) shall be treated as a short-term capital loss of such spouse for the first taxable year beginning in 1942 to the extent of the excess of short-term capital gains over short-term capital losses of such spouse for such year.

(b) *Taxable years beginning after December 31, 1942.* In the case of a husband and wife making a joint return, 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.

If a husband and wife making a joint return for any taxable year beginning after December 31, 1942, did not make a joint return for the preceding taxable years (not exceeding five taxable years and beginning after December 31, 1941), 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 and beginning after December 31, 1941), 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 beginning after December 31, 1942, made a joint return for each of the preceding taxable years (not exceeding five taxable years and beginning after December 31, 1941), 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 by section 117 (e) (1).

The alternative taxes computed under section 117 (c) (2) are in lieu of taxes imposed by sections 11 and 12 and must be compared with the tax imposed by such sections to determine which tax is applicable. In computing the alternative taxes under section 117 (c) (2), in the case of a joint return, the determination of the excess of the net long-term capital gains over the net short-term capital losses is to be made by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

§ 29.117-6 *Gains and losses from short sales.* For income tax purposes, a short sale is not deemed to be consummated until delivery of property to cover the short sale, and the percentage of the recognized gain or loss to be taken into account under section 117 (b) from a short sale shall be computed according to the period for which the property so delivered was held. Thus, if a taxpayer made a short sale of shares of stock and covered the short sale by purchasing and delivering shares which he held for not more than six months, 100 percent of the recognized gain or loss would be taken into account under section 117 (b), even though he had on hand other shares of the same stock which he held for more than 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.

§ 29.117-7 *Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.* Section 117 (j) provides that the recognized gains and losses:

(a) From the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is:

(1) Of a character subject to the allowance for depreciation provided in section 23 (l), or

(2) Real property, and

(b) From the involuntary conversion of capital assets held for more than six months

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.

In determining whether such gains exceed such losses for the purposes of section 117 (j), losses upon the destruction in whole or in part, theft or seizure, requisition or condemnation of the property described in section 117 (j) are included whether or not there was a conversion of such 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) to determine whether gains exceed losses. Furthermore, in making this computation, the gains and losses described in section 117 (j) are taken into account without regard to the percentage provisions of section 117 (b), that is, 100 percent of such gains and losses is taken into account. For example, if a taxpayer sustains a loss of $400 upon the sale under threat of condemnation of a capital asset, held for more than six months, such loss is taken into account for the purposes of section 117 (j) to the extent of $400, even though only $200 would be taken into account under section 117 (b) in computing net income. Similarly, 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 as to sections 117 (b) and 117 (d), gains and losses are included in the computations under section 117 (j) 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 in computing net income for the taxable year is included in the computations 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).

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 (b), (c), and (d), relating to the percentage taken into account, the alternative tax in the case of capital gains and losses, and 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. Such gains and losses are then not subject to the percentage limitations of section 117 (b), and such losses are not subject to the limitations provided in section 117 (d). For example, if the taxpayer during the taxable year has losses of $1,000 on the sale of certain depreciable machinery used in his trade or business, held for more than six months, and a gain of $400 on the sale under threat of condemnation of a capital asset held for more than six months, such losses exceed such gain, and such losses and gain are not treated as losses and gain from the sale or exchange of capital assets. The gain on the sale of the capital asset would therefore be taken into account in full, instead of to the extent of 50 percent as provided in section 117 (b).

Section 117 (j) does not apply to gains and losses on the sale, exchange, or involuntary conversion of any property 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 his trade or business. The involuntary conversion of property described in section 117 (j) 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.

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 1942 of the kind described in section 117 (j), computed without regard to the limitations in section 117 (b), 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 six months	$4,000	
2. Gain reported in 1942 (under section 44) on installment sale in 1941 of factory premises used in the business (including building and land, each held for more than six months)	6,000	
3. Gain reported in 1942 (under section 44) on installment sale in 1942 of land held for more than six 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 six 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 six 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 six months		5,000
7. Loss in storm of pleasure yacht, purchased in 1940 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. Therefore, under the provisions of section 117 (b), A will take into account only 50 percent of the amounts of items 1 to 7. Such items are treated the same as any other long-term gains and losses of A, and will cause the inclusion of $1,750 (50 percent of item 10) in computing his net long-term capital gain for the purposes of the alternative tax provided by section 117 (c) (2).

Example (2). A's yacht, used for pleasure and acquired for such use in 1935 at a cost of $25,000, was requisitioned by the Government in 1942 for $15,000. A sustained nondeductible loss, and no loss with respect to such requisition will be included in the computations under section 117 (j).

Example (3). If in example (1) the taxpayer were a corporation, then there would be taken into account 100 percent of the gains and losses in items 1 to 7, which are treated for all purposes as gains and losses from the sale or exchange of capital assets held for more than six months. The percentage provisions of section 117 (b) do not apply to corporations. These items will cause the inclusion of $3,500 (item 10) in computing the net long-term capital gain of the corporation for the purposes of the alternative tax provided by section 117 (c) (1).

Example (4). 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. Since all of such items are included in full in computing net income, the net effect of such items will be the inclusion in computing net income of a loss of $500 (the excess of the $13,000 losses over the $12,500 gains). This same result would be obtained if A were a corporation. If the loss on the sale of the capital asset under threat of condemnation were $3,500, the gains and losses would still be treated as ordinary gains and losses and not as capital gains and losses, since the gains ($12,500) would not exceed the losses ($9,000 plus $3,500, or $12,500).

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.

§ 29.118-1 *Losses from wash sales of stock or securities.* (a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities, if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this 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 indentical 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 se-

curities 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 § 29.22 (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 § 29.113 (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 acquisiton) of the stock or securties 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.

Example (1). A, whose taxable year is the calendar year, on December 1, 1941, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1941, purchased 100 additional shares for $9,000. On January 2, 1942, he sold the 100 shares purchased on December 1, 1941, 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, 1941, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1941, he purchased 50 shares of substantially identical stock for $2,750, and on December 26, 1941, he purchased 25 additional shares of such stock for $1,125. On January 2, 1942, he sold for $4,000 the 100 shares purchased on September 21, 1941. 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, 1941, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 2, 1942, is $2,500 (the cost of 50 of the shares sold on January 2, 1942), plus $750 (the difference between the purchase price of the 50 shares acquired on December 21, 1941 ($2,750), and the selling price of 50 of the shares sold on January 2, 1942 ($2,000)), or $3,250. Similarly the basis of the 25 shares purchased on December 26, 1941, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 2, 1942, is $1,250 plus $125, or $1,375. (See § 29.113 (a) (10)-1.)

Example (3). A, whose taxable year is the calendar year, on September 15, 1940, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1942, for $4,000. On each of the four days from February 15, 1942, to February 18, 1942, 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, 1942, 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, 1942, and the 50 shares purchased on February 16, 1942. In determining the period for which the 50 shares purchased on February 15, 1942, and the 50 shares purchased on February 16, 1942, were held, there is to be included the period for which the 100 shares purchased on September 15, 1940, and sold on February 1, 1942, were held.

SEC. 119. INCOME FROM SOURCES WITHIN UNITED STATES [as amended by sec. 160 (c), Rev. Act 1942]. (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 the provisions of this section, for the three-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or

(B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for the purposes of section 131 (relating to foreign tax credit), be treated as income from sources without the United States;

(3) *Personal services.* Compensation for labor or personal services performed in the United States, but in the case of a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of ninety days during the taxable year, compensation received by such an individual (if such compensation does not exceed $3,000 in the aggregate) for labor or services performed as an employee of or under a contract with a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, shall not be deemed to be income from sources within the United States;

(4) *Rentals and royalties.* Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) *Sale of real property.* Gains, profits, and income from the sale of real property located in the United States.

(6) *Sale of personal property.* For gains, profits, and income from the sale of personal property, see subsection (e).

(b) *Net income from sources in United States.* From the items of gross income specified in subsection (a) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) *Gross income from sources without United States.* The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in subsection (a) (1) of this section;

(2) Dividends other than those derived from sources within the United States as provided in subsection (a) (2) of this section;

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

(5) Gains, profits, and income from the sale of real property located without the United States.

(d) *Net income from sources without United States.* From the items of gross income specified in subsection (c) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which 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.

(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".

§ 29.119-1 *Income from sources within the United States.* Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States. Citizens of the United States and domestic corporations entitled to the benefits of section 251 are, however, taxable upon income received within the United States, whether derived from sources within or without the United States. (See sections 212 (a), 231 (c), and 251.)

The Internal Revenue Code divides the income of such taxpayers into three classes:

(a) Income which is derived in full from sources within the United States;

(b) Income which is derived in full from sources without the United States; and

(c) Income which is derived partly from sources within and partly from sources without the United States.

The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.

§ 29.119-2 *Interest.* There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations which are entitled to the benefits of section 251, all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:

(a) Interest paid on deposits with persons, including individuals, partnerships, or corporations, carrying on the banking business, to persons (nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251) not engaged in business within the United States;

(b) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States (as determined under the provisions of section 119) for the 3-year period ending with the close of the taxable year of the payor which precedes the payment of such interest, or for such part of that period as may be applicable; and

(c) Income derived by a foreign central bank of issue from bankers' acceptances. A foreign central bank of issue means a bank which is by law or government sanction the principal authority (other than the government itself) issuing instruments intended to circulate as currency. Such banks are generally the custodians of the banking reserves of their countries.

Any taxpayer who excludes from gross income from sources within the United States income of the type specified in paragraph (a), (b), or (c) 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 in those paragraphs.

Interest received from the United States by a foreign corporation or a nonresident alien on a refund of Federal income taxes is taxable as income from sources within the United States.

As to the inclusion in gross income of items received in the United States even though representing income from sources without the United States, in the case of citizens of the United States and domestic corporations entitled to the benefits of section 251, see § 29.251-2.

§ 29.119-3 *Dividends.* Gross income from sources within the United States includes dividends, as defined by section 115:

(a) From a domestic corporation other than one entitled to the benefits of section 251, and other than a corporation less than 20 percent of the gross income of which is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of section 119, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence); or

(b) From a foreign corporation unless the 50 percent of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends, or for such part of such period as it has been in existence, was derived from sources within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for the purposes of section 131, relating to credits for taxes of foreign countries and possessions of the United States, dividends from a foreign corporation shall be treated as income from sources without the United States.

Dividends will be treated as income from sources within the United States (except for the purposes of section 131) unless the taxpayer submits sufficient data to establish to the satisfaction of the Commissioner that they should be excluded from gross income under para-

graph (a) or (b) of this section. (See also section 116 (f).)

§ 29.119-4 *Compensation for labor or personal services.* Except as provided in section 119 (a) (3), gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. Except as provided in section 119 (a) (3), wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

§ 29.119-5 *Rentals and royalties.* Gross income from sources within the United States includes rentals or royalties from property located within the United States or from any interest in such property, including rentals or royalties for the use of or the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States.

§ 29.119-6 *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.

§ 29.119-7 *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 § 29.119-4);

(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, good will, trademarks, trade brands, franchises, and other like property (see § 29.119-5); and

(e) Gain derived from the sale of real property located without the United States (see sections 111 to 113, inclusive).

§ 29.119-8 *Sale of personal property.* Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold, except that income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. A possession of the United States constitutes a "country," within the meaning of this 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 § 29.119-12.)

§ 29.119-9 *Deductions in general.* 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.

§ 29.119-10 *Apportionment of deductions.* From the items specified in §§ 29.119-1 to 29.119-6, inclusive, 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 1942 of $180,000, including therein:

Interest on bonds of a domestic corporation	$9,000
Dividends on stock of a domestic corporation	4,000
Royalty for the use of patents within the United States	12,000
Gain from sale of real property located within the United States	11,000
Total	36,000

that is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under § 29.119-7.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000 is properly allocated to income from sources within the United States and the amount of $40,000 is properly allocated to income from sources without the United States.

The remainder of the expenses, $30,000, cannot be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States.

§ 29.119-11 *Other income from sources within the United States.* Items of gross income other than those specified in section 119 (a) and (c) shall be allocated or apportioned to sources within or without the United States, as provided in section 119 (e).

The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in § 29.119-12.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

§ 29.119-12 *Income from the sale of personal property derived from sources*

partly within and partly without the United States. Items of gross income not allocated by § 29.119-1 to 29.119-8, inclusive, or § 29.119-11, to sources within or without the United States shall (unless unmistakably from a source within or a source without the United States) be treated as derived from sources partly within and partly without the United States. Such income derived from the sale of personal property may be divided into two classes: (a) Income derived from sources partly within the United States and partly within a foreign country, and (b) income derived from sources partly within the United States and partly within a possession of the United States.

(a) The portion of such income derived from sources partly within the United States and partly within a foreign country which is attributable to sources within the United States shall be determined according to the following rules and cases:

Personal property produced and sold. Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a foreign country under one of the cases set forth below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1 A. Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established — unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all cases the basis of the accounting shall be fully explained in a statement attached to the return.

Case 2 A. Where an independent factory or production price has not been established as provided under Case 1 A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such net income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. The 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 this paragraph refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, and the term "property" includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Case 3 A. Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed, the income derived from sources within the United States.

(b) The portion of such income derived from sources partly within the United States and partly within a possession of the United States which is attributable to sources within the United States shall be determined according to the following rules and cases:

Personal property produced and sold. Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the cases set forth below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1 B. Same as case 1 A.

Case 2 B. Where an independent factory or production price has not been established as provided under case 1 A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which 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 de-

nominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term "property" as used in this paragraph includes only the property held or used to produce income which is derived from such sales.

Case 3 B. Same as case 3 A.

Personal property purchased and sold. Gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the following cases:

Case I B. The net income shall first be computed by deducting from such gross income the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The amount of net income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such net income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Case II B. Same as case 3 A.

§ 29.119-13 *Transportation service.* A foreign corporation carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(a) The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (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.

In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States should be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses should ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage, and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. Income, war-profits, and excess-profits taxes should not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and for such purpose, interest and other expenses for the use of borrowed capital should not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the Internal Revenue Code should be taken.

The value of the property used should be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken should be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year. Current assets should be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries should be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries should be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States should be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries. For ships the average should be determined upon a daily basis for each ship and the amount to be apportioned for each ship as assets employed within the United States should be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(b) 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 (a), (1) the expenses of the transportation business carried on within the United States as determined under paragraph (a), and (2) the expenses determined in accordance with paragraphs (c) and (d).

(c) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in paragraph (a); 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.

(d) 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 (a); 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.

(e) 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 (a) to (d), inclusive, the income derived from sources within the United States.

§ 29.119-14 *Telegraph and cable service.* A foreign corporation carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(a) *Gross income.* The gross income from sources within the United States derived from such services 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.

(b) *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 (a), (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 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 busines therein, and (4) a proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in (1), (2), and (3)) 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.

§ 29.119-15 *Computation of income.* If a taxpayer has gross income from sources within or without the United States as defined by section 119 (a) or (c) together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated, and the net income from sources within the United States shall be separately computed therefrom.

SEC. 120. UNLIMITED DEDUCTION FOR CHARITABLE AND OTHER CONTRIBUTIONS.

In the case of an individual if in the taxable year and in each of the ten preceding taxable years the amount of the contributions or gifts described in section 23 (o) (or corresponding provisions of prior revenue Acts) plus the amount of income, war-profits, or excess-profits taxes paid during such year in respect of preceding taxable years, exceeds 90 per centum of the taxpayer's net income for each such year, as computed without the benefit of the applicable subsection, then the 15 per centum limit imposed by section 23 (o) shall not be applicable.

§ 29.120-1 *Unlimited deduction for charitable and other contributions.* Under the circumstances specified in section 120, the 15 percent limitation imposed by section 23 (o) on the deduction for charitable and other contributions is not applicable.

In the case of a husband and wife making a joint return for any taxable year, the 15 percent limitation on the deduction for contributions or gifts imposed by section 23 (o) shall not be applicable if the aggregate amount of the contributions or gifts described in section 23 (o) (or corresponding provisions of prior Revenue Acts) made by the spouses in the taxable year and in each of the 10 preceding years, plus the aggregate amount of income, war-profits, or excess-profits taxes paid by the spouses during such year in respect of preceding taxable years, exceeds 90 percent of the aggregate net income of the spouses for each such year, as computed without the benefit of any deduction for contributions or gifts.

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 [as added by sec. 211 (b), Rev. Act 1939, and amended by secs. 105 (e), 150 (e), 153 (a) (b) (c), Rev. Act 1942].

(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.* If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) *Net operating loss carry-over.* If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed 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).

(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 credit provided in section 26 (e)).

(d) *Exceptions 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) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117 (b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains;

(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.

(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules—

(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

(B) Such tax shall be computed without regard to the adjustment provided in section 734; and

(C) Such tax, in the case of a consolidated return for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

(e) *No carry-back to year prior to 1941.* As used in this section, the term "preceding taxable year" and the term "preceding taxable years" do not include any taxable year beginning prior to January 1, 1941.

§ 29.122-1 *Net operating loss deduction*—(a) *General.* 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.

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. For the purpose of determining such carry-overs, the net operating loss for any taxable year may be carried over to the two succeeding taxable years. If the taxable year began on or after January 1, 1942, the net operating loss for such taxable year may also be carried back to the two preceding taxable years, not considering as a preceding taxable year any year which began before January 1, 1941. 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. Therefore, the net operating loss carry-overs to a taxable year beginning on or after January 1, 1942, are the net operating loss for the first preceding taxable year and so much of the net operating loss for the second preceding taxable year as has not been absorbed by the net income (computed under section 122), if any, for the first preceding taxable year, and the net operating loss carry-backs to such a taxable year are the net operating loss for the second succeeding taxable year and so much of the net operating loss for the first succeeding taxable year as has not been absorbed by the net income (computed under section 122), if any, for the first preceding taxable year. If either of the taxable years preceding the taxable year for which the deduction is allowed began on or after January 1, 1942, the net operating loss for such preceding taxable year is first reduced to the extent it has been absorbed by the net income (computed under section 122), if any, for the taxable years to which such loss has been carried back.

A fractional part of a year which is a taxable year under section 48 (a) is a preceding or succeeding taxable year for the purpose of determining under section 122 the first, second, or third preceding taxable year or the first or second succeeding taxable year.

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 the two preceding taxable years and for the two succeeding taxable years. 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-backs to the taxable year from such succeeding taxable years. The third is the conversion of the aggregate of such net operating loss carry-overs and carry-backs 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 prior to the filing of the claim for credit or refund of such overpayment or prior to the filing of a petition with The Tax Court of the United States asserting such overpayment, whichever is earlier. If the taxpayer files a claim based upon the overpayment caused by a carry-back from the first succeeding taxable year, and later ascertains that he is entitled to a carry-back from the second succeeding taxable year, he should file a second claim for credit or refund based on the overpayment, if any, caused by the failure to take into account the carry-back from such second succeeding taxable year.

§ 29.122-2 *Computation of net operating loss in case of corporation.* 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:

(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 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;

(c) No net operating loss deduction shall be allowed;

(d) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of long-term capital losses shall not exceed the amount includible on account of long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of short-term capital gains. For any taxable year beginning after December 31, 1941, 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 sales or exchanges of such assets; and

(e) For taxable years beginning after December 31, 1941, there shall be allowed as a deduction the amount of excess profits tax imposed by subchapter E of chapter 2 paid or accrued within the taxable year, subject, however, to the provisions of section 122 (d) (6) (A), (B), and (C).

The application of this section may be illustrated by the following example:

Example. For the year 1942 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. Included in gross income are long-term capital gains of $50,000 and short-term capital gains of $25,000. The corporation had long-term capital losses of $60,000 and short-term capital losses of $35,000, which are deductible to the extent of the capital gains, or $75,000. The X Corporation also 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 1942 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 1942 of $110,000, computed as follows:

(1) Deductions for 1942		$600,000
Less:		
(2) 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 1942	$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 1942 (item (3) minus item (6))		110,000

§ 29.122-3 *Computation of net operating loss in case of a taxpayer other than a corporation*—(a) *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 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) Long-term capital gains and long-term capital losses shall be taken into account without regard to the percentage provisions of section 117 (b);

(5) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of business long-term and short-term capital losses shall not exceed the amount includible on account of the business long-term and short-term capital gains, respectively, plus an allocable portion of any nonbusiness long-term and short-term capital gains, computed in accordance with paragraph (c) of this section; and for any taxable year beginning after December 31, 1941, 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;

(6) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of nonbusiness long-term and short-term capital losses shall not exceed the amount includible on account of nonbusiness long-term and short-term capital gains, respectively, and for any taxable year beginning after December 31, 1941, the amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains: and

(7) 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 (i) for any taxable year beginning after December 31, 1938, and before January 1, 1942, the excess, if any, of nonbusiness long-term and short-term capital gains over nonbusiness long-term and short-term capital losses, respectively, and (ii) for any taxable year beginning after December 31, 1941, the excess, if any, of nonbusiness capital gains over nonbusiness capital losses.

(b) *Treatment of carry-overs*—(1) *Taxable years beginning before 1943.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has, for any taxable year beginning after December 31, 1938, and before January 1, 1943, a net short-term capital loss carry-over from the preceding taxable year, includible among his short-term capital losses for the current taxable year by virtue of section 117 (e), must determine how much of such net short-term capital loss carry-over is a business and how much is a nonbusiness short-term capital loss. In order to make this determination, the taxpayer must first ascertain what proportion of the net short-term capital loss for the preceding taxable year was attributable to an excess of business short-term capital losses over business short-term capital gains for such year, and what proportion was attributable to an excess of nonbusiness short-term capital losses over nonbusiness short-term capital gains. The same proportions of the net short-term capital loss carry-over from such preceding taxable year shall be treated as a business short-term capital loss and a nonbusiness short-term capital loss, respectively.

This rule may be illustrated by the following examples:

Example (1). Without considering any short-term capital loss carry-over to the taxable year 1941. A, an individual, has the following short-term capital gains and losses for such taxable year:

Business short-term capital gains of $1,000 and nonbusiness short-term capital gains of $500, business short-term capital losses of $1,600 and nonbusiness short-term capital losses of $600. A's net short-term capital loss for the taxable year 1941 is $700, computed as follows:

Short-term capital losses ($1,600 plus $600)	$2,200
Less: Short-term capital gains ($1,000 plus $500)	1,500
Net short-term capital loss for 1941	700

Since the business short-term capital losses exceeded the business short-term capital gains by $600 ($1,600 minus $1,000), $600 of the $700 net short-term capital loss is attributable to such excess. Similarly, $100 is attributable to an excess of nonbusiness short-term capital losses over nonbusiness short-term capital gains. Assuming that the net short-term capital loss carry-over to 1942 from 1941 is also $700, then the same amounts will be treated as business and nonbusiness short-term capital losses, respectively, i. e., $600 will be treated as a business short-term capital loss and $100 as a nonbusiness short-term capital loss.

Example (2) Assume the same facts as in the previous example except that the net short-term capital loss carry-over to 1942 from 1941 is only $350, because of the limitations contained in section 117 (e). Since six-sevenths ($600) of the $700 net short-term capital loss for 1941 was attributable to an excess of business short-term capital losses over gains and one-seventh ($100) was attributable to an excess of nonbusiness short-term capital losses over gains, six-sevenths, or $300, of the $350 short-term capital loss carry-over from 1941 to 1942 shall be treated as a business short-term capital loss, and one-seventh, or $50, shall be treated as a nonbusiness short-term capital loss.

(2) *Taxable years beginning after December 31, 1942.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has, for any taxable year beginning after December 31, 1942, 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.

The effect of this subparagraph may be illustrated by the following example:

Example. A, an individual, has the following short-term gains and losses for the calendar year 1943: Business short-term capital gains of $1,000 and nonbusiness short-term capital gains of $500, business short-term capital losses of $1,600 and nonbusiness short-term capital losses of $600, business long-term capital gains of $1,000 and nonbusiness long-term capital gains of $500, business long-term capital losses of $1,600 and nonbusiness long-term capital losses of $600. A's net capital loss for the taxable year 1943 is $1,400, computed as follows:

Short-term capital losses ($1,600 plus $600)		$2,200
Long-term capital losses ($1,600 plus $600)		2,200
Total capital losses		4,400
Short-term capital gains ($1,000 plus $500)	1,500	
Long-term capital gains ($1,000 plus $500)	1,500	
Total capital gains		3,000
Net capital loss for 1943		1,400

Since business capital losses exceeded business capital gains by $1,200 ($3,200 minus $2,000), $1,200 of the $1,400 net capital loss is attributable to such excess. Similarly, $200 is attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. Assuming that the net capital loss carry-over to 1944 from 1943 is also $1,400, then the same amounts will be treated as business and nonbusiness capital losses, respectively, i. e., $1,200 will be treated as a business capital loss and $200 as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses*—(1) *Taxable years beginning before 1942.* In the computation of a net operating loss a taxpayer other than a corporation must, for taxable years beginning after December 31, 1938, and before January 1, 1942, first use his nonbusiness long-term and short-term capital gains for the deduction of his nonbusiness long-term and short-term capital losses, respectively. See paragraph (a) (6) 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) (7) of this section. The remainders, computed by applying the excess ordinary nonbusiness deductions proportionately against the excess long-term and excess short-term capital gains, shall be treated as long-term and short-term capital gains, respectively, and may be used for the purpose of determining the deductibility of business long-term and short-term capital losses under paragraph (a) (5) of this section.

Example. A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Long-term capital gains	6,000
Short-term capital gains	7,000
Total gross income	20,500

He also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Long-term capital losses	2,000
Short-term capital losses	5,000
Total deductions	16,000

In order to determine the portion of the nonbusiness long-term and short-term capital gains available for the deduction of business long-term and short-term capital losses there must first be deducted the amounts of the nonbusiness long-term and short-term capital losses, respectively. It is then found that the excess long-term capital gains amount to $4,000 ($6,000 minus $2,000), and the excess short-term capital gains to $2,000 ($7,000 minus $5,000). Since the ordinary nonbusiness deductions exceed the ordinary nonbusiness gross income by $1,500 ($9,000 minus $7,500), $1,500 of the $4,000 excess long-term and $2,000 excess short-term capital gains must be used to permit the allowance of such $1,500 under paragraph (a) (7) of this section. Two-thirds of the $1,500 excess of ordinary deductions over ordinary gross income, i. e., $1,000, will therefore be deducted from the $4,000 of excess long-term capital gains, leaving $3,000 to be added to the business long-term capital gains for the purpose of determining the deductibility of any business long-term capital losses. Similarly, one-third of the $1,500 excess of ordinary deductions over ordinary gross income, i. e., $500, will be deducted from the $2,000 excess short-term capital gains, leaving $1,500 to be added to the business short-term capital gains, for the purpose of determining the deductibility of any business short-term capital losses.

(2) *Taxable years beginning after December 31, 1941.* In the computation of a net operating loss a taxpayer other than a corporation must, for taxable years beginning after December 31, 1941, use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. See paragraph (a) (6) 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) (7) 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) (5) of this section.

Example. A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Long-term capital gains	6,000
Short-term capital gains	7,000
Total gross income	20,500

He also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Long-term capital losses	2,000
Short-term capital losses	5,000
Total deductions	16,000

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) (7) 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.* A, an individual who makes his income tax returns on a calendar year basis, has gross income of $483,000 and deductions (exclusive of a net operating loss deduction) of $600,000 for 1942. Included in gross income are business long-term capital gains (as defined in section 117 (a) (4)) of $25,000 (amount of actual gain $50,000) on assets held for more than 24 months, and nonbusiness income of $10,000. Included among the deductions are a business long-term capital loss (as defined in section 117 (a) (5)) of $30,000 (amount of actual loss $60,000) on a capital asset held for 19 months, and deductions incurred in transactions not connected with a trade or business of $12,000. A has no other items of income or deductions to which section 122 (d) is applicable.

On the basis of these facts A has a net operating loss for 1942 of $110,000, computed as follows:

(1) Deductions for 1942, exclusive of capital losses ($600,000 minus $30,000)		$570,000
(2) Plus amount of actual capital loss ($60,000) to extent such amount does not exceed actual capital gains ($50,000)		50,000
(3) Sum of items (1) and (2)		620,000
(4) Less excess of nonbusiness deductions over nonbusiness income ($12,000 minus $10,000)		2,000
(5) Deductions adjusted as required by section 122 (d) (item (3) minus item (4))		618,000
(6) Gross income for 1942	$483,000	
(7) Plus excess of long-term capital gains actually realized over amount previously taken into account ($50,000 minus $25,000)	25,000	
(8) Gross income adjusted as required by section 122 (d) (item (6) plus item (7))		508,000
(9) Net operating loss for 1942 (item (5) minus item (8))		110,000

For treatment of depletion deductions and tax-free interest, see example in § 29.122-2. For treatment of net short-term capital loss carry-over, 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 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.

§ 29.122-4 *Computation of net operating loss carry-overs and net operating loss carry-backs*—(a) *In general.* The aggregate of any net operating loss carry-overs and any net operating loss carry-backs 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 the two preceding taxable years which are carry-overs to the current taxable year, and the part of any net operating losses for the two succeeding taxable years which are carry-backs to the current taxable year.

Under section 122 the net operating loss for any taxable year beginning on or after January 1, 1942, may be carried back to the two preceding taxable years (except any such taxable year which began before January 1, 1941) and may be carried over to the two succeeding tax-

able years. The net operating loss for any taxable year beginning before January 1, 1942, may be carried over to the two succeeding taxable years, regardless of whether such year begins before, on, or after January 1, 1941. The amount which is so 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.* The net operating loss sustained in any taxable year beginning before January 1, 1942, may be carried over to the two succeeding taxable years. The entire net operating loss may be carried over to the first succeeding taxable year, and the carry-over to the second succeeding taxable year is the excess of the net operating loss over the net income, if any, for the first succeeding taxable year (computed as provided in paragraph (c) of this section). For example, the taxpayer had a net operating loss of $10,000 in 1940. It had a 1941 net income of $6,000 (computed as provided in paragraph (c) of this section). The carry-over from 1940 to 1942 is $4,000, the excess of the $10,000 loss over the $6,000 net income for 1941.

The net operating loss sustained in any taxable year beginning on or after January 1, 1942, may be carried back to the two preceding taxable years (not considering as a preceding taxable year a year beginning prior to January 1, 1941) and may be carried over to the two succeeding taxable years. The entire net operating loss may be carried back to the second preceding taxable year. However, if the second preceding taxable year began before January 1, 1941, no part of the net operating loss may be carried back to such taxable year, and the net income for such taxable year does not reduce the amount of the net operating loss which may be carried back or carried over to the other taxable years. The net operating loss, to the extent it exceeds the net income, if any (computed as provided in paragraph (c) of this section), for the second preceding taxable year, may then be carried back to the first preceding taxable year. To the extent that the net operating loss exceeds the aggregate of the net income, if any (computed as provided in paragraph (c) of this section), for the two preceding taxable years, it may be carried over to the first succeeding taxable year. To the extent that the net operating loss exceeds the aggregate of the net income, if any (computed as provided in paragraph (c) of this section), for the two preceding taxable years and for the first succeeding taxable year, it may be carried over to the second succeeding taxable year.

Example. The taxpayer has a net operating loss of $100,000 in 1943. It has net income (computed as provided in paragraph (c) of this section) as follows: $10,000 in 1941, $15,000 in 1942, $35,000 in 1944, and $60,000 in 1945. The net operating loss carry-back from 1943 to 1941 is $100,000, an amount equal to the full net operating loss. The carry-back to 1942 is $90,000, the excess of the $100,000 net operating loss over the $10,000 net income for 1941 (computed as provided in paragraph (c) of this section). The carry-over to 1944 is $75,000, the excess of the $100,000 net operating loss over the aggregate of the $10,000 net income for 1941 and the $15,000 net income for 1942 (computed in each instance as provided in paragraph (c) of this section). The carry-over to 1945 is $40,000, the excess of the $100,000 net operating loss over the aggregate of the $10,000 net income for 1941, the $15,000 net income for 1942, and the $35,000 net income for 1944 (computed in each instance as provided in paragraph (c) of this section).

(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 by taking into account only such net operating losses otherwise allowable as carry-overs or carry-backs 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.

Example. In computing the net operating loss deduction for 1945, the taxpayer has a carry-over from 1943 of $9,000, a carry-over from 1944 of $6,000, a carry-back from 1946 of $18,000, and a carry-back from 1947 of $14,000, or an aggregate of $47,000 in carry-overs and carry-backs which is the basis for the deduction. In computing the net income for 1945 which is deducted from the net operating loss for 1946 in order to determine the portion of such net operating loss which may be carried over to 1947 or 1948, the net operating loss deduction for 1945 is computed without taking into account the $18,000 carry-back from 1946 or the $14,000 carry-back from 1947. The net operating loss deduction for 1945 is, for the purposes of such computation, the aggregate of the $9,000 carry-over from 1943 and the $6,000 carry-over from 1944, or $15,000, adjusted as provided in § 29.122-5 (relating to the conversion of the aggregate of the net operating loss carry-overs and carry-backs to the taxable year into the net operating loss deduction).

In computing the net income for 1945 which is deducted from the net operating loss for 1947 in order to determine the portion of such loss which may be carried back to 1946 and carried over to 1948 and 1949, the net operating loss deduction for 1945 is computed without taking into account the $14,000 carry-back from 1947, and as so computed is the aggregate of the $9,000 carry-over from 1943, the $6,000 carry-over from 1944, and the $18,000 carry-back from 1946, or $33,000, adjusted as provided in § 29.122-5.

(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 § 29.122-2), except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) above.

(3) In the case of a taxpayer other than a corporation, the net income shall be computed in accordance with the first four exceptions, additions, and limitations specified in § 29.122-3 (a), except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) above. In lieu of the last three exceptions specified in § 29.122-3 (a), the taxpayer is required only (i) for a taxable year beginning before January 1, 1942, to restrict the amount of his deductions for long-term and short-term capital losses to the amount of his long-term and short-term capital gains, respectively, and (ii) for a taxable year beginning on or after January 1, 1942, to restrict the amount of his deduction for capital losses to the amount of his capital gains. The ordinary nonbusiness deductions are allowed in full if otherwise allowable by law. The exceptions and limitations dependent upon the distinction between business and nonbusiness 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 shall be recomputed upon the basis of the net income determined with the adjustments prescribed in the preceding paragraphs.

(5) The net income, as adjusted, shall in no case be considered less than zero.

(d) *Illustration of computation of net operating loss carry-backs 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 1939 or 1940, or in 1948 or 1949. 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 1941, $35,000 in 1942, $30,000 in 1946, and $85,000 in 1947. It sustained net operating losses as follows: $25,000 in 1943, $50,000 in 1944, and $40,000 in 1945. It is assumed for the purposes of this example that the application of § 29.122-5 does not cause any reduction of the amount of the aggregate of the net operating loss carry-overs and carry-backs to any taxable year, so that such aggregate is the net operating loss deduction for such taxable year.

(1) The portions of the $25,000 net operating loss for 1943 which may be used as carry-backs to 1941 and 1942 and as carry-overs to 1944 and 1945 are computed as follows:

(a) For 1941, the carry-back is $25,000, that is, the amount of the net operating loss.

(b) For 1942, the carry-back is $5,000, that is, the excess of the $25,000 net operating loss over the $20,000 net income for 1941 (such net income being determined without

any net operating loss deduction since there is no carry-over to 1941 from 1939 or 1940 and no carry-back from 1942, and the carry-back from 1943 is not taken into account).

(c) For 1944 and 1945, there is no carry-over of the net operating loss for 1943 since such loss does not exceed $55,000, the sum of the net incomes for the two taxable years preceding 1943 computed as provided in paragraph (c) of this section (the $20,000 net income for 1941 and the $35,000 net income for 1942, there being no net operating loss deduction for either taxable year since the carry-backs from 1943 and from 1944 are not taken into account).

(2) The portions of the $50,000 net operating loss from 1944 which may be used as carry-backs to 1942 and 1943 and as carry-overs to 1945 and 1946 are computed as follows:

(a) For 1942, the carry-back is $50,000, that is, the amount of the net operating loss.

(b) For 1943, the carry-back is $20,000, that is, the excess of the $50,000 net operating loss over the $30,000 net income for 1942 (the $35,000 income for 1942 reduced by the $5,000 carry-back from 1943, the carry-back from 1944 not being taken into account).

(c) For 1945, the carry-over is $20,000, that is, the excess of the $50,000 net operating loss over $30,000, the sum of the $30,000 net income for 1942 (computed with the deduction of the $5,000 carry-back from 1943 and without the deduction of the carry-back from 1944) and the $0 net income for 1943 (a year in which a net operating loss was sustained).

(d) For 1946, the carry-over is $20,000, that is, the excess of the $50,000 net operating loss over $30,000, the sum of the $30,000 net income for 1942 (computed with the deduction of the $5,000 carry-back from 1943 and without the deduction of the carry-back from 1944) and the $0 net income for 1943 and 1945 (years in which net operating losses were sustained).

(3) The portions of the $40,000 net operating loss for 1945 which may be used as carry-backs to 1943 and 1944 and as carry-overs to 1946 and 1947 are computed as follows:

(a) For 1943, the carry-back is $40,000, that is, the amount of the net operating loss.

(b) For 1944, the carry-back is $40,000, that is, the excess of the $40,000 net operating loss for 1945 over $0, the net income for 1943 (a year in which a net operating loss was sustained).

(c) For 1946, the carry-over is $40,000, that is, the excess of the $40,000 net operating loss for 1945 over $0, the sum of the net incomes for 1943 and 1944 (years in which net operating losses were sustained).

(d) For 1947, the carry-over is $30,000, that is, the excess of the $40,000 net operating loss for 1945 over $10,000, the sum of the $0 net incomes for 1943 and 1944 and the $10,000 net income for 1946 (such net income for 1946 being computed as the $30,000 income reduced by the net operating loss carry-over of $20,000 from 1944, the $40,000 carry-over to 1946 from 1945 not being taken into account).

For 1941, the net operating loss deduction is determined to be $25,000, that is, the carry-back from 1943.

For 1942, the net operating loss deduction is determined to be $55,000, that is, the aggregate of the carry-back of $5,000 from 1943 and of the carry-back of $50,000 from 1944.

For 1946, the net operating loss deduction is determined to be $60,000, that is, the aggregate of the $20,000 carry-over from 1944 and the $40,000 carry-over from 1945.

For 1947, the net operating loss deduction is determined to be $30,000, that is, the carry-over from 1945.

(e) *Joint return by husband and wife.* 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.

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 the preceding paragraphs of this section but upon the basis of the joint net operating losses and the combined net income of both spouses.

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 the preceding paragraph of this section, but with the following exceptions and limitations:

(1) The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be the portion of the joint net operating loss (computed in accordance with § 29.122-3 (e)) 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.

(2) 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 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:

(i) 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

(ii) 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 operating 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 (*b*) of the next sentence).

For the purposes of (i) and (ii) above, 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:

(*a*) The exceptions, additions, and limitations provided in section 122 (d) (1), (2), and (4) shall apply, and

(*b*) 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.

In the following examples, which illustrate subparagraphs (1) and (2) above, 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 taxpayers 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 1941 and 1942. They sustained a joint net operating loss of $1,000 for 1941 and a joint net operating loss of $2,000 for 1942. For 1941, 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 1941 is considered the net operating loss of H for 1941, and $300 of such joint net operating loss is considered the net operating loss of W for 1941. For 1942 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 1942 is considered the separate net operating loss of W for 1942.

Example (2). H and W filed joint returns for 1939 and 1941, and separate returns for 1940 and 1942. For such years they had net incomes and net operating losses as follows:

	1939	1940	1941	1942
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.

The net operating loss carry-over of H from 1942 to 1943 is $4,000, that is, his $4,000 net operating loss for 1942 which is not reduced by any part of the net income for 1941, 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 1942, which taxable year begins on the same date as H's taxable year 1942. The determination of

the amount ($0) of net income for 1941 which reduces H's net operating loss for 1942 is made as follows:

The combined net income of $9,500 for 1941 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, 1942, the date of the beginning of the taxable year in which H sustained the net operating loss which is a carry-over to 1943. This $8,500 amount is composed of H's carry-overs of $5,000 from 1939 and $2,500 from 1940, or a total of $7,500, and of W's carry-over of $1,000 from 1939 (the excess of W's $3,000 loss for 1939 over her $2,000 income for 1940). None of the $1,000 combined net income for 1941 (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 1941 which is attributable to W is used to reduce H's net operating loss for 1942 since such net income attributable to W must first be reduced by W's $1,500 net operating loss for 1942, 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.

The net operating loss carry-over of W from 1942 to 1943 is $500, her $1,500 loss reduced by the $1,000 net income for 1941, computed in the manner prescribed in the preceding paragraph, since all of such net income is attributable to her.

Example (3). Assume the same facts as in example (2), except that for 1942 the net operating loss of W is $200 instead of $1,500.

The net operating loss carry-over of H from 1942 to 1943 is $3,200, that is, his $4,000 net operating loss reduced by $800 of the net income for 1941, computed as follows:

The combined net income for 1941, 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 1942, a taxable year beginning on the same date (January 1, 1942) as the taxable year of H (1942) in which he sustained the $4,000 net operating loss from which the net income is subtracted. See paragraph (2) (ii) above.

W has no net operating loss carry-over from 1942 to 1943 since her net operating loss of $200 for 1942 does not exceed the $1,000 net income for 1941 attributable to her.

Example (4). Assume the same facts as in example (2) except that W changes her accounting period in 1942 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1942, to January 31, 1942, but has a net operating loss of $200 for the fiscal year February 1, 1942, to January 31, 1943.

The net operating loss carry-over of H from 1942 to 1943 is $3,000, that is, his net operating loss of $4,000 for 1942 reduced by the $1,000 net income for 1941, computed as follows:

The combined net income for 1941, 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, 1942, 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.

The net operating loss carry-over of W from the fiscal year beginning February 1, 1942, 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 1941, since there is no net income for 1941 when computed for the purpose of determining the carry-over of W's net operating loss for her fiscal year beginning February 1, 1942. For such purpose, the net income of $9,500 for 1941 is reduced to $0 by the net operating loss deduction for such year of $12,500, computed without taking into account any net operating loss sustained in a taxable year beginning on or after February 1, 1942, the date of the beginning of the taxable year in which W sustained the net operating loss which is the basis for the carry-over. This $12,500 amount is composed of H's carry-overs of $5,000 from 1939 and $2,500 from 1940, and his carry-back of $4,000 from 1942 (the calendar year beginning January 1, 1942), and of W's carry-over of $1,000 from 1939 (the excess of her $3,000 loss for 1939 over her $2,000 income for 1940).

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 subparagraphs (1) and (2) above. 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 this paragraph a joint return was filed for 1943, 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.

The joint net operating loss carry-overs and joint net operating loss carry-backs to any taxable year for which 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 1943. The wife filed a separate return for the calendar years 1941 and 1942, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1942, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1942. 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 1943 from 1941 and 1942 (see the preceding paragraphs of this section), the joint net operating loss carry-overs to 1943 are the separate net operating loss carry-overs of the wife from the calendar years 1941 and 1942 and the separate net operating loss carry-overs of the husband from the fiscal year ending June 30, 1942, and from the short taxable year ending December 31, 1942. If the husband and wife also filed joint returns for the calendar years 1944 and 1945, having joint net income in 1944 and a joint net operating loss in 1945, the joint net operating loss carry-back to 1943 from 1945 is computed upon the basis of the joint net operating loss for 1945, since separate returns were not made for any taxable year involved in the computation of such carry-back.

§ 29.122-5 *Conversion of net operating loss carry-over into net operating loss deduction.* The net operating loss deduction for any taxable year is the aggregate of the net operating loss carry-overs and carry-backs to such taxable year computed as prescribed in § 29.122-4, 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 § 29.122-4 except that no net operating loss deduction shall be taken into account and no deduction for excess profits tax imposed by subchapter E of chapter 2 shall be taken into account) over:

(a) In the case of a taxpayer other than a corporation, the net income computed without regard to the exceptions and limitations specified in § 29.122-3 (a) except that no net operating loss deduction shall be taken into account; or

(b) In the case of a corporation, the normal-tax net income computed without regard to the exceptions, additions, and limitations specified in § 29.122-2 except that no net operating loss deduction shall be taken into account and the credit provided in section 26 (e) for income subject to the excess profits tax shall not be allowed.

The application of this section may be illustrated by the following example:

Example. The aggregate of the net operating loss carry-overs and carry-backs to 1942 for the X Corporation is $55,000. Its net income for 1942, 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 credit provided in section 26 (e) for income subject to the excess profits tax is not allowed, is $445,000. The net operating loss deduction available to the X Corporation for the year 1942 is $50,000, computed as follows:

Aggregate of net operating loss carry-overs and carry-backs to 1942	$55,000
Less: Excess of net income for 1942, with adjustments, over normal-tax net income for 1942, without adjustments except that no net operating loss deduction shall be allowed and the credit provided in section 26 (e) for income subject to the excess profits tax shall not be allowed ($450,000 minus $445,000)	5,000
Net operating loss deduction for 1942	50,000

If the same facts are assumed for an individual, except that, instead of having a normal-tax net income for 1942 of $445,000, he has a net income in such year of $445,000, computed without adjustment except that no net operating loss deduction shall be allowed, his net operating loss deduction for 1942 will likewise be $50,000, computed in the same manner.

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 the first paragraph of this section) is to be made upon the basis of the aggregate of the joint net operating loss carry-overs and joint net operating loss carry-backs of the spouses to such year (computed as prescribed in § 29.122-4 (e)) and the combined net income of the spouses.

SEC. 123. COMMODITY CREDIT LOANS [as added by sec. 223 (a), Rev. Act 1939, and amended by sec. 154 (a), Rev. Act 1942].

(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) The election provided for in subsection (a) with respect to taxable years beginning after December 31, 1938, and before January 1, 1942, may be exercised by the taxpayer at, or at any time prior to, the time prescribed for the filing of the taxpayer's return for the taxable year of the taxpayer beginning in 1942, or if there is more than one taxable year of the taxpayer beginning in 1942, for the last taxable year so beginning, provided the records of the taxpayer are sufficient to permit an accurate computation of income for such years, and the taxpayer consents in writing to the assessment, within such period as may be agreed upon, of any deficiency for such years, even though the statutory period for the assessment of any such deficiency had expired prior to the filing of such consent.

§ 29.123-1 *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.

§ 29.123-2 *Effect of election on adjustments for other taxable years.* 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:

(a) 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

(b) 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.

Example. A, a taxpayer who elected for his taxable years 1938, 1939, and 1940 to include in gross income amounts received during those years as loans from the Commodity Credit Corporation, received as loans $500 in 1938, $700 in 1939, and $900 in 1941. In 1942 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 1938 and 1939, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1941. A, in making his return for 1942, 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.

SEC. 124. AMORTIZATION DEDUCTION [as added by sec. 302, 2d Rev. Act 1940, and amended by secs. 1-3, Pub. Law 3, approved January 31, 1941; secs. 1-3, Pub. Law 285, approved October 30, 1941; Pub. Law 436, approved February 6, 1942; sec. 155 (a) (b) (c) (d) (e) (f), Rev. Act 1942].

(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 (e)), 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 (g) 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.

(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 shall (except as provided in subsection (d) (3)) be made only by a statement to that effect in its return for the taxable year in which the facility was completed or acquired. Its election to take the amortization deduction and to begin such period with the taxable year succeeding such year shall be made only by a statement to that effect in its return for such succeeding taxable year. In the case of an emergency facility completed or acquired (1) after December 31, 1939, and before June 11, 1940, by a corporation, or (2) after December 31, 1939, and before January 1, 1942, by a person other than a corporation, the taxpayer's election to take the amortization deduction and to begin such period with either the month following the month in which the facility was completed or acquired or with the succeeding taxable year shall be made only by a statement in writing to that effect to the Commissioner and shall be made before the expiration of six months after the date of enactment of the Revenue Act of 1942.

(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 Commissioner 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 (except as provided in subsection (d)) be entitled to any further amortization deductions with respect to such emergency facility.

(d) *Termination of amortization period.* (1) If the President has proclaimed the ending of the emergency period (as defined in subsection (e)), or if the Secretary of War or the Secretary of the Navy has, in accordance with regulations prescribed by the President, certified to the Commissioner that an emergency facility ceased, on the date specified in the certificate, to be necessary in the interest of national defense during the emergency period, and if the date of such proclamation or the date specified in such certificate occurs within sixty months from the beginning of the amortization period with respect to such emergency facility, then the taxpayer may elect (in accordance with paragraph (4) of this subsection) to terminate the amortization period with respect to such emergency facility as of the end of the month in which such proclamation was issued or in which occurred the date specified in such certificate, whichever is the earlier. In such case the amortization period with respect to such facility shall end with the end of such month in lieu of the end of the sixty-month period.

(2) If the date of the proclamation or the date specified in the certificate referred to in paragraph (1) of this subsection occurs within sixty months from the beginning of the amortization period with respect to such emergency facility and after the beginning of the month which the taxpayer has previously fixed under subsection (c) for the taking, in lieu of the amortization deduction provided in this section, of the deduction allowed by section 23 (l), the taxpayer may elect (in accordance with paragraph (4) of this subsection) to terminate the amortization period with respect to such emergency facility as of the end of the month in which such proclamation was issued or in which occurred the date specified in such certificate, whichever is the earlier. In such case the amortization period with respect to such facility shall end with the end of such month in lieu of the end of the sixty-month period, and the termination of the amortization deduction under subsection (c) shall be disregarded.

(3) In the case of a taxpayer which has not elected, in the manner prescribed in subsection (b), to take an amortization deduction with respect to an emergency facility, if the date of the proclamation or the date specified in the certificate, referred to in paragraph (1) of this subsection, whichever is earlier, is before the expiration of sixty months from the last day of the month in which such emergency facility was completed or acquired, then the taxpayer may elect (in accordance with paragraph (4) of this subsection) the amortization deduction provided in subsection (a), using an amortization period beginning with the month following the month in which the emergency facility was completed or acquired and ending as of the end of the month within which such proclamation was issued or within which occurred the date specified in such certificate, whichever is the earlier.

(4) The election provided in paragraph (1), (2), or (3) shall be made by filing with the Commissioner, in such manner, in such form,

and within such time, as the Commissioner with the approval of the Secretary may by regulations prescribe, a statement of such election. When such election has been so made, then, under regulations prescribed by the Commissioner with the approval of the Secretary, the taxes for all taxable years, beginning with the taxable year in which the amortization period began, shall be computed in accordance with an amortization deduction computed in accordance with the method provided in subsection (a), but using (in lieu of the sixty-month period provided in such subsection) the amortization period specified in paragraph (1), (2), or (3), as the case may be.

(5) *Recomputation of tax in case of election under this subsection.* If the adjustment of the income or excess-profits tax liability for any taxable year necessary to give effect to paragraph (4) of this subsection is prevented (A) on the date of the certificate of the Secretary of War or the Secretary of the Navy or on the date of the President's proclamation, whichever is the basis of the taxpayer's election under this subsection, or (B) within one year from such date, by any provision of law (other than this paragraph and other than section 3761, relating to compromises), an adjustment of the tax liability shall nevertheless be made if in respect of such taxable year a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within one year after the date of such certificate or such proclamation, whichever is the basis of the taxpayer's election under this subsection. 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 in this paragraph shall be limited to the increase or decrease in the tax previously determined for such taxable year which results solely from the effect of paragraph (4) of this subsection, 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 such certificate or such proclamation, whichever is the basis of the taxpayer's election under this subsection, one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for the taxable year. The tax previously determined shall be ascertained in accordance with section 3801 (d). The amount to be assessed and collected under this paragraph in the same manner as if it were a deficiency, or to be refunded or credited 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 paragraph (4) of this subsection. 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 paragraph (4) of this subsection.

(6) In the case of a taxpayer which has not elected, in the manner prescribed in subsection (b), to take an amortization deduction with respect to an emergency facility, if the date of the proclamation referred to in paragraph (1) of this subsection or the date specified in the certificate referred to in paragraph (1) of this subsection is before the completion of such emergency facility, then the taxpayer may elect (in accordance with paragraph (4) of this subsection) the amortization deduction provided in subsection (a), using an amortization period beginning with the month in which the construction, reconstruction, erection, or installation of the emergency facility was begun and ending as of the end of the month within which such proclamation was issued or within which occurred the date specified in the certificate referred to in paragraph (1) of this subsection, whichever is the earlier.

(e) *Definitions*—(1) *Emergency facility.* As used in this section, the term "emergency facility" means any facility, land, building, machinery, or equipment, or part thereof, the construction, reconstruction, erection, installation, or acquisition of which was completed after December 31, 1939, and with respect to which a certificate under subsection (f) has been made. For the purposes of this section, the part of any facility which was constructed, reconstructed, erected, or installed by any person after December 31, 1939, and not earlier than six months prior to the filing of an application for a certificate under subsection (f), and with respect to which part a certificate under subsection (f) has been made, 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. For the purposes of this section, the part of any facility which was constructed, reconstructed, erected, or installed by a corporation after December 31, 1939, and before June 11, 1940, and with respect to which part a certificate under subsection (f) has been made, shall be deemed to be an emergency facility and to have been completed on June 10, 1940, notwithstanding that the entire facility was not completed until after June 10, 1940.

(2) *Emergency period.* As used in this section, the term "emergency period" means the period beginning January 1, 1940, 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 (f) have been made is no longer required in the interest of national defense.

(f) *Determination of adjusted basis of emergency facility.* In determining, for the purposes of subsection (a) or subsection (h), the adjusted basis of an emergency facility—

(1) There shall be included only so much of the amount otherwise constituting such adjusted basis as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1939, as either the Secretary of War or the Secretary of the Navy has certified as necessary in the interest of national defense during the emergency period, which certification shall be under such regulations as may be prescribed from time to time by the Secretary of War and the Secretary of the Navy, with the approval of the President.

(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 and shall be considered as an expenditure with respect to a new emergency facility; and

(3) The certificate provided for in paragraph (1) shall have no 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 December 1, 1941, whichever is later, except that—

(A) in the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, such certificate shall have no effect unless an application therefor is filed before the expiration of six months after the date of the enactment of the Revenue Act of 1942, and

(B) in the case of an emergency facility completed or acquired after December 31, 1939, by a person other than a corporation, such certificate shall have no 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 the enactment of the Revenue Act of 1942, whichever is later.

In no event and notwithstanding any of the other provisions of this section, no amortization deduction shall be allowed in respect of any emergency facility for any taxable year—

(C) unless a certificate in respect thereof under paragraph (1) shall have been made (i) prior to the filing of the taxpayer's return for such taxable year, or prior to the making of an election pursuant to subsection (d) (3) or subsection (d) (6) of this section to take the amortization deduction, or (ii) before December 1, 1941, whichever is later; or

(D) in the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, unless a certificate in respect thereof under paragraph (1) shall have been made prior to the expiration of twelve months after the date of enactment of the Revenue Act of 1942; or

(E) in the case of an emergency facility completed or acquired after December 31, 1939, and before January 1, 1943, by a person other than a corporation, unless a certificate in respect thereof under paragraph (1) shall have been made (i) prior to the expiration of nine months after the last date upon which an application for such certificate may be filed, or (ii) prior to the expiration of twelve months after the date of enactment of the Revenue Act of 1942, whichever is later.

(g) *Depreciation deduction.* If the adjusted basis of the emergency facility computed without regard to subsection (f) of this section is in excess of the adjusted basis computed under such subsection, 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 were an amount equal to the amount of such excess.

(h) *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 this paragraph, 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 the amount so includible, but such deduction 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 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 either the Secretary of War or the Secretary of the Navy 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 grounds (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 contracts 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).

(i) *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.

§ 29.124-0 *Definitions.* As used in this section and §§ 29.124-1 to 29.124-9, inclusive, the term:

(a) "Secretary of the department concerned" means the Secretary of War or the Secretary of the Navy, as the case may be.

(b) "Emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof:

(1) The acquisition of which occurred after December 31, 1939, or the construction, reconstruction, erection, or installation of which was completed after such date, and

(2) Any part of the construction, reconstruction, erection, installation, or acquisition of which has, under such regulations as may be prescribed by the Secretary of War and the Secretary of the Navy, with the approval of the President, been certified by the Secretary of the department concerned as necessary in the interest of national defense during the emergency period.

The part of any facility which is constructed, reconstructed, erected, or installed by any person after December 31, 1939, and not earlier than six months prior to the filing of an application for a certificate of necessity under section 124 (f), and which is certified by the Secretary of the department concerned as necessary in the interest of national defense during the emergency period, 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. If the construction, reconstruction, erection, or installation of a facility by a corporation is begun before June 11, 1940, and completed after June 10, 1940, the part of such facility which is constructed, reconstructed, erected, or installed after December 31, 1939, and before June 11, 1940, shall be deemed to be an emergency facility, provided such part is certified by the Secretary of the department concerned as necessary in the interest of national defense during the emergency period.

The term "emergency facility," as so defined, may include, among other things, improvements of land, such as the construction of airports and the dredging of channels.

(c) "Emergency period" means the period beginning on January 1, 1940, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities is no longer required in the interest of national defense.

§ 29.124-1 *Certificate of necessity.* The certification by the Secretary of the department concerned that a facility is necessary in the interest of national defense during the emergency period shall have no effect:

(a) In the case of an emergency facility completed or acquired by a corporation after June 10, 1940, unless an application therefor is filed before the expiration of six months after the beginning of the construction, reconstruction, erection, or installation of such facility or the date of its acquisition, or before December 1, 1941, whichever is later (but see § 29.124-0 (b));

(b) In the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, unless an application therefor is filed before April 22, 1943; and

(c) In the case of an emergency facility completed or acquired after December 31, 1939, by a person other than a corporation, unless an application therefor is filed before the expiration of six months after the beginning of the construction, reconstruction, erection, or installation of such facility or the date of its acquisition, or before April 22, 1943, whichever is later.

§ 29.124-2 *Amortization deduction; general rule.* If the Secretary of the department concerned makes the required certification of necessity, a person is entitled, at its election, to a deduction with respect to the amortization of the adjusted basis of an emergency facility, such amortization to be based generally on a period of 60 months. As to the adjusted basis of an emergency facility, see § 29.124-6. 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 § 29.124-3). The date on which, or the month within which, an emergency facility is completed or acquired is a question 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. If the construction, reconstruction, erection, or installation of an emergency facility by a corporation is begun before June 11, 1940, and completed after June 10, 1940, the part of such emergency facility which is constructed, reconstructed, erected, or installed after December 31, 1939, and before June 11, 1940, shall be deemed to have been completed on June 10, 1940.

With respect to an emergency facility, no amortization deduction shall be allowed for the taxable year in which or with which the taxpayer elects to begin the 60-month amortization period unless:

(a) In the case of an emergency facility completed or acquired by a corporation after June 10, 1940, a certificate of necessity in respect thereof shall have been made (1) before the filing of the taxpayer's return for such taxable year, or before the making of an election pursuant to section 124 (d) (3) or section 124 (d) (6) to take the amortization deduction, or (2) before December 1, 1941, whichever is later;

(b) In the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, unless a certificate of necessity in respect thereof shall have been made before October 22, 1943;

(c) In the case of an emergency facility completed or acquired by a person other than a corporation after December 31, 1942, unless a certificate of necessity in respect thereof shall have been made before the filing of the taxpayer's return for such taxable year, or before the making of an election pursuant to section 124 (d) (3) or section 124 (d) (6); or

(d) In the case of an emergency facility completed or acquired after December 31, 1939, and before January 1, 1943, by a person other than a corporation, unless a certificate of necessity in respect thereof shall have been made (1) before the expiration of nine months after the last date upon which an application for such certificate may be filed or (2) before October 22, 1943, whichever is later.

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 § 29.124-7, relative to depreciation with respect to any amount not subject to amortization.

This section may be illustrated by the following examples:

Example (1). On July 1, 1942, 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, 1942, at a cost of $240,000. The certificate of necessity 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 1942 is $12,000, computed as follows:

Monthly amortization deductions:

October ($240,000÷60)	$4,000
November ($236,000, or $240,000 minus $4,000÷59)	4,000
December $232,000, or $236,000 minus $4,000,÷58)	4,000
Total amortization deduction for 1942	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, 1943. On June 15, 1943, it begins the construction of an emergency facility (No. 2), which is completed on August 2, 1943. The entire acquisition and construction of such facilities are certified as necessary in the interest of national defense. The Y Corporation elects to take amortization deduction 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. The adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000 at the end of the first month of the amortization period. In September 1943 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, 1943, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:

August ($300,000÷60)	$5,000	
September ($269,630, or $300,000 minus $5,000 and $25,370,÷59)	4,570	
October ($265,060, or $269,630 minus $4,570, ÷ 58)	4,570	
November ($260,490, or $265,060 minus $4,570, ÷ 57)	4,570	
Amortization deduction for 1943		$18,710

Facility No. 2

Monthly amortization deductions:

September ($54,000÷60)	$900	
October ($53,100÷59)	900	
November ($52,200÷58)	900	
Amortization deduction for 1943		2,700
Total amortization deduction for 1943		21,410

Example (3). On June 15, 1941, 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 1941, filed on March 15, 1942, 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 of necessity with respect to such facility is made until April 10, 1942, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1941. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1941, 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 1942 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1942, 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÷54)	$2,000
February ($106,000, or $108,000 minus $2,000, ÷ 53)	2,000
March ($104,000, or $106,000 minus $2,000, ÷ 52)	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization for 1942	24,000

Since the Z Corporation elected in its return for 1941 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1941, it must compute its amortization deductions for the 12 months in the taxable year 1942 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

Example (4). On March 18, 1940, the R Corporation, which makes its income tax returns on the calendar year basis, begins the construction of a facility which is completed on October 25, 1940, at a cost of $350,000, of which $132,000 is attributable to construction before June 11, 1940, and $218,000 to construction after June 10, 1940. On January 28, 1941, the entire part of the construction after June 10, 1940, is certified as an emergency facility, and the R Corporation, in its income tax return for 1940, elects to take amortization deductions with respect thereto and to begin the 60-month amortization period with November 1940, the month following the month of completion. With respect to the part of the construction before June 11, 1940, the R Corporation in its returns for 1940 and 1941, takes depreciation deductions aggregating $5,000. On February 14, 1943, the entire part of the construction before June 11, 1940, is certified as a separate emergency facility. The R Corporation, in a statement in writing to the Commissioner made before April 22, 1943, elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1940, the month following the month of completion. For such purposes, the adjusted basis of such facility at the end of July 1940 is $132,000. Since amortization deductions are in lieu of depreciation deductions, the depreciation deductions of $5,000 previously taken for 1940 and 1941 are disallowed. The allowable amortization deduction with respect to such facility for the taxable year 1940 is $13,200, computed as follows:

Monthly amortization deductions:

July ($132,000÷60)	$2,200
August ($129,800÷59)	2,200
September ($127,600÷58)	2,200
For the remaining three months (similarly computed)	6,600
Total amortization deduction for 1940	13,200

The allowable amortization deduction with respect to such facility for the taxable year 1941, similarly computed, is $26,400.

Example (5). On April 1, 1940, A, an individual, who makes his income tax returns on a calendar year basis, acquires a facility at a cost of $182,700. In his returns for the taxable years 1940 and 1941, A takes depreciation deductions with respect to such facility of $2,700 and $3,600, respectively. On February 6, 1943, the facility is certified as an emergency facility and A, in a statement in writing made to the Commissioner before April 22, 1943, elects to take amortization deductions with respect thereto and to begin the 60-month amortization period with the taxable year 1941, the year succeeding the year in which the facility was acquired. The adjusted basis of such facility at the end of January 1941 is $180,000 ($182,700 less the depreciation of $2,700 taken in the return for 1940). Since amortization deductions are in lieu of depreciation deductions, the depreciation deduction of $3,600 previously taken for 1941 is disallowed. The allowable amortization deduction with respect to such facility for the taxable year 1941 is $36,000, computed as follows:

Monthly amortization deductions:

January ($180,000÷60)	$3,000
February ($177,000÷59)	3,000
March ($174,000÷58)	3,000
For the remaining nine months (similarly computed)	27,000
Total amortization deductions for 1941	36,000

§ 29.124-3 *Election of amortization.* In the case of an emergency facility completed or acquired (1) after June 10, 1940, by a corporation or (2) after December 31, 1941, by a person other than a corporation:

(a) An election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period with the month following the month in which such facility was completed or acquired shall be made only by a statement to that effect in its return for the taxable year in which such facility was completed or acquired; and

(b) An election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period with the taxable year succeeding that in which such facility was completed or acquired shall be made only by a statement to that effect in its return for such succeeding taxable year.

In the case of an emergency facility completed or acquired (1) after December 31, 1939, and before June 11, 1940, by a corporation, or (2) after December 31, 1939, and before January 1, 1942, by a person other than a corporation, an election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period either with the month following the month of completion or acquisition or with the following taxable year shall be made only by a statement in writing to that effect filed with the Commissioner of Internal Revenue, Washington, D. C., before April 22, 1943.

No other method of making such elections 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 provided in section 124 (b), to take amortization deductions with respect to an emergency facility shall not, except as provided in sections 124 (d) (3) and 124 (d) (6), be entitled to amortization deductions with respect to such facility (see § 29.124-5 (d)).

§ 29.124-4 *Election to discontinue amortization.* 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 specifying the month as of the beginning of which the taxpayer elects to discontinue the 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, except as provided in section 124 (d), be entitled to any further amortization deductions with respect to such facility (see § 29.124-5 (c)).

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 pertaining thereto, 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).

This section may be illustrated by the following example:

Example. On July 1, 1942, 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 of necessity 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 1943. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1942. On March 25, 1944, the corporation files notice with the Commissioner of its election to discontinue the amortization deductions beginning with the month of April 1944. The adjusted basis of the facility on January 31, 1943, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1942 ($6,000). The amortization deduction for the taxable year 1943 and the months of January, February, and March, 1944, amounts to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1943), 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, 1944, 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.

§ 29.124-5 *Termination of amortization period*—(a) *Date the emergency use ceases.* As used in this section, the term "date the emergency use ceases" means whichever of the following is the earlier:

(1) The date of the proclamation by the President by reason of which the emergency period ends; or

(2) The date specified in a certificate with respect to an emergency facility made to the Commissioner by the Secretary of the department concerned (in accordance with regulations prescribed by the President) as the date on which such facility ceased to be necessary in the interest of national defense during the emergency period.

(b) *Taxpayer which has elected to amortize.* A taxpayer which has elected to take amortization deductions with respect to an emergency facility may elect, in the manner provided in paragraph (e) of this section, to terminate the amortization period with respect to such facility as of the end of the month in which occurs the date the emergency use ceases, provided that such date occurs prior to the expiration of the original 60-month period. In such case there shall, with respect to such facility, be substituted, in lieu of the original 60-month period, a new amortization period beginning with the first month of the original 60-month period and ending with the end of the month in which occurs the date the emergency use ceases; and the taxpayer's taxes for all taxable years (beginning with the taxable year in which the original 60-month period began) shall be computed (or recomputed) so as to give effect to amortization deductions with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of the new amortization period.

Example. On August 15, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility for the purpose of performing War Department contracts. The corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with September 1942, the month following the month of acquisition. The Secretary of War certifies to the Commissioner that such facility ceases, as of July 15, 1944, to be necessary in the interest of national defense. The X Corporation elects to terminate the amortization period and, accordingly, there is to be substituted, in lieu of the 60-month amortization period, a new amortization period of 23 months (4 months in 1942, 12 months in 1943, and 7 months in 1944). The X Corporation's taxes for the taxable years 1942, 1943, and 1944 shall be computed or recomputed so as to give effect to amortization deductions computed in the manner provided in section 124 (a) but on the basis of the new 23-month amortization period.

(c) *Taxpayer which has elected to discontinue amortization.* A taxpayer which has elected to take amortization deductions with respect to an emergency facility and has subsequently elected under section 124 (c) (see § 29.124-4) to discontinue, as of the beginning of a specified month, the amortization deductions with respect to such facility may elect, in the manner provided in paragraph (e) of this section, to terminate the amortization period with respect to such facility as of the end of the month in which occurs the date the emergency use ceases, provided that such date occurs prior to the expiration of the original 60-month period and after the beginning of such specified month. In such case, with respect to such facility, the election to discontinue the amortization deductions shall be disregarded and there shall be substituted, in lieu of the original 60-month period, a new amortization period beginning with the first month of the original 60-month period and ending with the end of the month in which occurs the date the emergency use ceases. The taxpayer's taxes for all taxable years (beginning with the taxable year in which the original 60-month period began) shall be computed (or recomputed) so as to give effect to amortization deductions with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of the new amortization period.

Example. On November 1, 1942, the Y Corporation, which makes its income tax returns on the basis of a fiscal year ending June 30, begins the construction of an emergency facility which is completed on March 15, 1943. The corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with April 1943, the month following the completion. On January 15, 1944, the corporation files a notice with the Commissioner in which it elects to discontinue the amortization deductions with respect to such facility as of the beginning of February 1944. The President issues a proclamation on August 16, 1944, by reason of which the emergency period ends. The Y Corporation then elects to terminate the amortization period and, accordingly, its election to discontinue the amortization deductions is to be disregarded. In such case, there is to be substituted, in lieu of the original 60-month amortization period, a new amortization period of 17 months (3 months in the taxable year ending June 30, 1943, 12 months in the taxable year ending June 30, 1944, and 2 months in the taxable year ending June 30, 1945). The corporation's taxes for the taxable years ending June 30, 1943, 1944, and 1945, are to be computed or recomputed so as to give effect to amortization deductions (in lieu of amortization and depreciation deductions previously taken during such 17-month period) computed in the manner provided in section 124 (a) but on the basis of the new 17-month amortization period.

If the date the emergency use ceases should occur between the date of the notice of discontinuance and the beginning of the month specified in such notice, the provisions of section 124 (d) (1) and paragraph (b) of this section are applicable.

(d) *Taxpayer which has not elected to amortize*—(1) *General rule.* A taxpayer which has obtained the required certifications but has not elected, as provided in section 124 (b), to take amortization deductions with respect to the emergency facility to which such certifications relate may nevertheless take amortization deductions with respect to such facility, if (i) the date the emergency use ceases occurs before the expiration of 60 months from the last day of the month in which such facility was completed or acquired, and (ii) an election to take such amortization deductions is made in the manner prescribed in paragraph (e) of this section. In such case, the taxes for all taxable years (beginning with the taxable year in which fell the month following the month in which such facility was completed or acquired) shall be computed (or recomputed) so as to give effect to amortization deductions

with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of an amortization period beginning with the month following the month in which such facility was completed or acquired, and ending with the last day of the month in which occurs the date of the emergency use ceases.

Example. On September 25, 1942, the Z Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility for the purpose of performing Navy Department contracts. The corporation does not elect to take amortization deductions with respect to such facility. The Secretary of the Navy certifies to the Commissioner that such facility ceased, as of July 20, 1944, to be necessary in the interest of national defense. The Z Corporation may elect, in the manner provided in paragraph (e) of this section, to take amortization deductions with respect to such facility and in such case its taxes for the taxable years 1942, 1943, and 1944 are to be computed or recomputed so as to give effect to amortization deductions computed in the manner provided in section 124 (a) but on the basis of an amortization period of 22 months (3 months in 1942, 12 months in 1943, and 7 months in 1944), such amortization deductions to be in lieu of depreciation deductions previously taken during such 22-month period.

(2) *Special rule with respect to incompleted facilities.* If the date the emergency use ceases occurs after the beginning of the construction, reconstruction, erection, or installation of an emergency facility and such construction, reconstruction, erection, or installation is not completed, the taxpayer may elect, in the manner prescribed in paragraph (e) of this section, to take amortization deductions with respect to such facility, such amortization to be based on a period beginning with the month in which the construction, reconstruction, erection, or installation of such facility was begun and ending as of the end of the month in which occurs the date the emergency use ceases.

(e) *Manner of making election.* The election described in paragraph (b), (c), or (d) of this section shall be made by filing with the Commissioner of Internal Revenue, Washington, D. C., a statement of such election. Such statement shall be filed within 90 days after the date of the President's proclamation or the date of the certificate of the Secretary of the department concerned, whichever is the basis of the taxpayer's election, and should contain a description clearly identifying the facility. A copy of such statement should be attached by the taxpayer to the income-tax return for the taxable year in which falls the date the emergency use ceases.

(f) *Recomputation of taxes in case of commuted amortization period.* The recomputation of the tax liability authorized by section 124 (d) (4) applies to any income or excess-profits tax imposed under chapter 1 or subchapter A, B, D, or E of chapter 2, to the capital stock tax imposed by chapter 6, and to any other tax of the corporation affected directly or indirectly by the recomputation of the amortization deduction.

Under section 124 (d) (5), if the adjustment of any income or excess-profits tax for any taxable year to give effect to the revised amortization deduction is prevented (1) on the date of the certificate of the Secretary of the department concerned or the date of the President's proclamation, whichever forms the basis of the taxpayer's election, or (2) within one year after such date, by any provision of law (other than section 3761, relating to compromises, and other than section 124 (d) (5) or by any rule of law, including the doctrine of res judicata, an adjustment shall nevertheless be made if a claim for refund or credit is filed or a notice of deficiency is mailed, as the case may be, within one year after the date of such certificate or proclamation. Section 124 (d) (5) applies only if, at the time of the filing of the claim for refund or the mailing of the notice of deficiency, the adjustment would otherwise be prevented by the running of the statute of limitations, by the execution of a closing agreement, by the operation of the rule of res judicata, or for other reasons. For reference to provisions which would prevent adjustment except for the provisions of section 124 (d) (5), see § 29.3801 (b)-0. Section 124 (d) (5) is not applicable, however, if on the date of the filing of the claim for refund or the mailing of the notice of deficiency, adjustment of the tax liability is permissible without recourse to such section.

The amount of the adjustment authorized by section 124 (d) (5) is limited to the increase or decrease in the tax previously determined for the taxable year which results solely from the revision of the amortization deduction and the collateral effects of such revision upon items of income, deductions, credits, invested capital, etc., already taken into account in ascertaining the tax previously determined. The tax previously determined for any taxable year is to be ascertained in accordance with the provisions of section 3801 (d). See § 29.3801 (d)-1. If the amount of the adjustment determined under section 124 (d) (5) represents an increase in tax, it is to be treated in the same manner as a deficiency for the taxable year; if it represents a decrease in tax, it is to be treated in the same manner as an overpayment for the taxable year. The amount of the adjustment considered as a deficiency or as an overpayment, as the case may be, will bear interest to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year for which the adjustment is made.

The amount of any adjustment under the provisions of section 124 (d) (5) which is refunded may not subsequently be recovered in a suit for erroneous refund based upon any adjustment other than one resulting from the revision of the amortization deductions. The amount of any adjustment under section 124 (d) (5) which is assessed and collected as a deficiency may not thereafter be recovered by the taxpayer in any suit for refund based upon any adjustment other than one resulting from the revision of the amortization deductions. The application of the provisions of section 124 (d) (5) may be illustrated by the following example:

Example. On August 31, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility at a cost of $300,000 and elects to take amortization deductions with respect to such facility over the 60-month period beginning with the month of September 1942. For the taxable year 1942 the corporation files an income tax return disclosing a net income of $73,800, corporation surtax net income of $65,300, and normal tax net income of $65,300. The return discloses a tax liability of $19,993, which is assessed and paid. In making such computation, the corporation takes amortization deductions of $5,000 a month for four months, or $20,000, but in computing its gross income erroneously omits interest income amounting to $6,000, and in computing its deductions erroneously omits a deduction for insurance expense of $2,000. The corporation includes in gross income dividends from a domestic corporation in the amount of $10,000 and takes a dividends received credit of $8,500. It also files an excess-profits tax return under subchapter E of chapter 2 disclosing an invested capital of $637,500, an excess-profits net income of $68,000, an excess-profits credit of $51,000 computed on the invested capital basis, and an excess-profits tax liability of $4,200.

On September 1, 1946, the Secretary of the department concerned certifies to the Commissioner that such emergency facility ceased as of August 15, 1946, to be necessary in the interest of national defense. The X Corporation elects to terminate the amortization period and to amortize the adjusted basis of such facility over the shortened period of 48 months beginning September 1, 1942, and ending August 31, 1946. The corporation is therefore entitled to compute or recompute its taxes for 1942, 1943, 1944, 1945, and 1946 on the basis of an amortization deduction of $6,250 in lieu of $5,000 for each month beginning with September 1942 and ending with August 1946. The allowable deduction for 1942 is therefore $25,000 in lieu of $20,000. Claims for refund for all years, except 1946, are filed on November 30, 1946. For the taxable year 1942 the period of limitations upon the filing of a claim for refund provided by section 322 expires on March 15, 1946. Since, however, the claim is filed within one year from the date of the certificate of the Secretary of the department concerned, an adjustment is authorized under section 124 (d) (5). The amount of the adjustment of the income taxes under sections 13 and 15 and the excess-profits tax under subchapter E of chapter 2 for 1942 is $2,758 (income taxes, $1,008; excess-profits tax, $1,750), computed as follows:

EXCESS-PROFITS TAX

Excess-profits net income reported		$68,000.00
Less: Additional deduction for amortization		5,000.00
Excess-profits net income as recomputed		63,000.00
Less:		
Excess-profits credit	$51,000.00	
Specific exemption	5,000.00	
		56,000.00
Adjusted excess-profits net income		7,000.00
Excess-profits tax as recomputed		2,450.00
Tax previously determined and paid		4,200.00
Amount of adjustment under section 124 (d) (5) to be refunded or credited		1,750.00

INCOME TAX

Net income upon which tax previously determined was based		$73,800.00
Less: Additional deduction for amortization:		
Amount deductible	$25,000.00	
Amount deducted in return	20,000.00	
		5,000.00
Balance		68,800.00
Add: Adjustment for excess-profits tax:		
Amount previously deducted	$4,200.00	
As recomputed	2,450.00	
		1,750.00
Net income as recomputed		70,550.00
Less: Dividends received credit		8,500.00
Corporation surtax net income		62,050.00
Less: Interest on obligations of the United States and its instrumentalities		None
Normal tax net income		62,050.00
Surtax on $25,000	$1,500.00	
Surtax on $37,050	2,593.50	
Normal tax on $62,050	14,892.00	
Income tax as recomputed		18,985.50
Income tax previously determined		19,993.00
Amount of adjustment under section 124 (d) (5) to be refunded or credited		1,007.50

By reason of the limitations imposed by section 124 (d) (5), the adjustment is limited to the decrease in the tax previously determined which results solely from the revision of the amortization deductions and the consequences flowing therefrom. Accordingly, the recomputation does not take into consideration the item of $6,000, representing interest received, which was omitted from gross income, or the item of $2,000, representing insurance expense, for which no deduction was allowed.

Since the claims for refund for the taxable years 1943, 1944, and 1945 were filed within the period of limitations provided in section 322, the provisions of section 124 (d) (5) are not applicable and the complete adjustment of the taxes for such taxable years may be made without regard to the limitations contained in section 124 (d) (5).

§ 29.124-6 *Adjusted basis of emergency facility*—(a) *In general.* The adjusted basis of an emergency facility for purposes 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 the certified construction, reconstruction, erection, installation, or acquisition after December 31, 1939. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

The unadjusted basis for amortization purposes, n cases where the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1939, and such construction, reconstruction, erection, installation, or acquisition is certified in its entirety by the Secretary of the department concerned as necessary in the interest of national defense during the emergency period, is the same as the unadjusted basis otherwise determined.

In cases where the Secretary of the department concerned certifies the entire construction, reconstruction, erection, installation, or acquisition after December 31, 1939, as necessary in the interest of national defense during the emergency period, but only a portion of the construction, reconstruction, erection, installation, or acquisition attributable to the facility takes place after December 31, 1939, the unadjusted basis for the purposes of amortization is so much of the entire unadjusted basis as is attributable to that portion of the construction, reconstruction, erection, installation, or acquisition which took place after December 31, 1939. For example, the X Corporation begins the construction of a facility November 15, 1939, and such facility is completed on April 1, 1940, at a cost of $500,000, of which $300,000 is attributable to construction after December 31, 1939. The certificate of necessity covers the entire construction after December 31, 1939, and the unadjusted basis of the emergency facility for amortization purposes is therefore $300,000. For depreciation of the remaining portion of the cost ($200,000), see § 29.124-7.

If the Secretary of the department concerned certifies only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1939, then the unadjusted basis for amortization purposes is limited to the amount attributable to such portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1939. Assuming the same facts as in the example in the preceding paragraph, except that the certificate is to the effect that only 50 percent of the construction after December 31, 1939, is necessary in the interest of national defense during the emergency period, the unadjusted basis for amortization purposes is 50 percent of $300,000, or $150,000.

Where a corporation begins the construction, reconstruction, erection, or installation of a facility before June 11, 1940, and completes it after June 10, 1940, the part of such construction, reconstruction, erection, or installation taking place after December 31, 1939, and before June 11, 1940, and the part thereof taking place after June 10, 1940, each constitutes a separate emergency facility, provided a certificate of necessity under section 124 (f) has been made with respect to each such part (see section 124 (e) and § 29.124-0). Furthermore, the part of such construction, reconstruction, erection, or installation taking place after December 31, 1939, and before June 11, 1940, is deemed to have been completed on June 10, 1940 (see section 124 (e) (1) and § 29.124-2). Accordingly, under such circumstances, in applying the foregoing rules for determining the unadjusted basis of the emergency facility representing the part of the construction, reconstruction, erection, or installation taking place after June 10, 1940, the date "June 10, 1940" should be substituted for the date "December 31, 1939."

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.) Amounts received by a taxpayer in connection with its agreement to supply articles for national defense, 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. 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, 1940, the entire unadjusted basis of which is $500,000 and the unadjusted basis of which for purposes of amortization is $300,000. The X Corporation elects to begin amortization on January 1, 1941. The only adjustment to basis for the period from July 1, 1940, to January 31, 1941, other than depreciation or amortization for January 1941, is $5,000 for depreciation for the last six months of 1940. The adjusted basis for purposes of amortization is therefore $300,000 less $3,000 (300,000/500,000ths of $5,000), or $297,000.

Example (2). On July 31, 1944, the Y Corporation has an emergency facility (a building) completed on July 1, 1940, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for purposes of amortization is $300,000. The corporation elects to begin amortization on January 1, 1941, by which time it is entitled to $5,000 depreciation for the last six months of 1940. On July 1, 1944, the facility is damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted bases of the emergency facility as of July 1944 for purposes of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to January 1, 1941	3,000.00	2,000.00	5,000
Adjusted basis January 1941	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,900.00	None	207,900
Less depreciation for 42 months	None	14,000.00	14,000
Adjusted basis at time of fire loss	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 purposes of amortization and the adjusted basis for purposes of depreciation in the proportion that each such adjusted basis at the time of such fire loss bears to their sum, i. e., 89,100/273,100ths of $200,000 or $65,250.82, against the amortization basis, and 184,000/273,100ths of $200,000 or $134,749.18, against the depreciation basis.

(b) *Capital additions.* If, after the completion or acquisition of an emergency facility with respect to which a certificate of necessity has been made, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not included in such certificate of necessity, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certificate. If such further expenditures are covered by a separate certificate of necessity made in accordance with the provisions of section 124 (f), they are treated as certified expenditures in connection with a new emergency facility, and, if proper election is made, will be taken into account in computing the adjusted basis of such new emergency facility for purposes of amortization.

Example. On March 1, 1942, the Secretary of the department concerned certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1942. The Z Corporation, on August 1, 1942, begins the installation in the plant of an additional boiler, which is not included in the certificate for the plant but is, prior to such installation, certified in a separate certificate as necessary in the interest of national defense. 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 emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

§ 29.124-7 *Depreciation of portion of emergency facility not subject to amortization.* The rule set forth in section 124 (a) (see § 29.124-2), that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable with respect to such facility, is subject to the exception provided in section 124 (g). Under this exception, if the property constituting such facility is depreciable property under section 23 (l) and the regulations pertaining thereto and if the adjusted basis of such facility as computed under section 113 (b) for purposes other than the amortization deductions (see § 29.113 (b) (1)-1) is in excess of the adjusted basis computed under section 124 (f) for purposes of the amortization deductions (see § 29.124-6), 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, 1939, 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 § 29.124-6). However, if the property constituting such facility is depreciable property under section 23 (l) and the regulations pertaining thereto, 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, 1939.

Similarly, if only a part of the construction, reconstruction, erection, installation, or acquisition after December 31, 1939, of an emergency facility has been certified by the Secretary of the department concerned as necessary in the interest of national defense during the emergency period, and if such facility is depreciable property under section 23 (l) and the regulations pertaining thereto, then the depreciation deduction provided by such section and regulations is allowable with respect to the part which has not been so certified.

For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in § 29.124-6 (a).

§ 29.124-8 *Payment by United States of unamortized cost of facility.* Section 124 (h) 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 the amount of any such payment is properly includible in gross income and has been certified, as provided in section 124 (h), 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 such amount as an amortization deduction with respect to such facility for the month in which such amount is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, and shall not in any case exceed the adjusted basis of such facility (see § 29.124-6), 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.

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 124 (f) and § 29.124-6 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 124 (h) (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.

This section may be illustrated by the following examples:

Example (1). On January 31, 1942, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate of necessity 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 1942, the month following the month of acquisition. On July 15, 1943, 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 1943. The adjusted basis of such facility for amortization purposes as of the end of July 1943, 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, 1942, 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 of necessity 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, 1944, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unamortized cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1944. The adjusted basis of the facility as of the end of August 1944, 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 1944 by the full amount of the $400,000 payment.

§ 29.124-9 *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.

SEC. 125. AMORTIZABLE BOND PREMIUM [as added by sec. 126 (b), Rev. Act 1942].

(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 amortzable bond premum for the taxable year shall be allowed as a deducton.

(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)).

(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 determing 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.

(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.

(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.

(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.

§ 29.125-1 *In general*—(a) *Application.* Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to:

(1) Fully tax-exempt bonds (the interest on which is excludible from gross income), whether the owner is a corporation, individual, or other taxpayer; and

(2) Partially tax-exempt bonds (the interest on which is subject only to surtax) owned by a corporation.

It is optional, at the election of the taxpayer, with respect to:

(1) 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

(2) Partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 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.

(b) *Operation.* 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.

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: (1) As an adjustment to the basis or adjusted basis of the bond; (2) as a deduction; and (3) 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 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).)

§ 29.125-2 *Bond premium and amortizable bond premium.* 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 § 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section 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)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer. The application of the preceding sentence relating to adjustments may be illustrated by the following examples:

Example (1). On January 1, 1942, T, who makes his income tax returns on the calendar year basis, owns a fully taxable $100 bond, maturing on January 1, 1952. T purchased this bond on January 1, 1932, for $120. T elects to have section 125 apply to such bond for 1942 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, 1952, 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 1932-1942.

Example (2). On January 1, 1942, X's father gave him a fully taxable $100 bond maturing on January 1, 1952. X's father had purchased the bond on January 1, 1932, 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 from 1942 to 1952. 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 1942–1952 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). On January 1, 1942, Y, who makes his income tax returns on the calendar year basis, owns a tax-exempt $100 bond, maturing on January 1, 1951. He purchased this bond on January 1, 1941, for $110. On December 31, 1944, Y sells the bond for $108 and thus realizes a gain of $1, computed as follows:

(1) Total bond premium ($110 minus $100)	$10
(2) Amount of bond premium amortization under section 125 (total bond premium minus unamortized bond premium attributable to 1941, $10 minus $1)	9
(3) Amount of bond premium amortized from January 1, 1942, through December 31, 1944 ($1 for each such year)	3
(4) Adjusted basis of bond at close of 1944 ($110 minus $3)	107
(5) Gain ($108 minus $107)	1

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.

§ 29.125-3 *Methods of amortization.* The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) 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 year beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the 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.

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 § 29.125-2 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 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.

§ 29.125-4 *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.

§ 29.125-5 *Callable and convertible bonds.* 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. 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.

§ 29.125-6 *Capitalized expenses.* 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 these regulations to use the method of amortization prescribed by § 29.125-3, 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 not required, to amortize such capitalized expenses in accordance with such method.

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 these regulations to use the method of amortization prescribed by § 29.125-3, 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 may, but is not required to treat such capitalized expenses as being part of the bond premium for the purposes of section 125.

§ 29.125-7 *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 these regulations to use the method of amortization prescribed by § 29.125-3, 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.

§ 29.125-8 *Bonds owned by decedents*—(a) *Cash basis decedents.* If a decedent on the cash receipts and disbursements basis owned fully taxable bonds and partially tax-exempt bonds to which section 125 applies:

(1) In the case of a fully taxable bond, 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 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

(2) In the case of a partially tax-exempt bond:

(i) 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;

(ii) The estate's or legatee's credit for such interest is not reduced on account of the amortizable bond premium for such period; and

(iii) 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.

The application of the foregoing provisions relating to a partially tax-exempt bond may be illustrated by the following example:

Example. At the time of his death in 1942, D owns a partially tax-exempt bond to which section 125 applies. For the period beginning January 1, 1942, 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 is allowable as a deduction in the return for 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 (1) above, 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.

§ 29.125-9 *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.

SEC. 126. INCOME IN RESPECT OF DECEDENTS. [as added by sec. 134 (e), Rev. Act 1942].

(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.

(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.

(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 880, 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.

§ 29.126-1 *Inclusion in gross income of income in respect of a decedent.* The gross income for the taxable year of a decedent beginning on or after January 1, 1943, 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 § 29.42-1. 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 § 29.42-1, 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. Furthermore, if his partnership agreement had provided for the sale to the other partners upon his death of his right to the partnership assets in return for a payment of a certain sum by the surviving partners to his estate, the gain on such sale, accrued solely by reason of his death, would not be included in computing his net income.

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 in a taxable year ending after December 31, 1942, 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.

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 disbursement 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.

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 coowner 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 exceed the adjusted basis of such assets in the hands of the decedent immediately prior to his death. This gain 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 acounting) 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 represent the gain on the sale.

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.

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.

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 6 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 engaged in place of the decedent in the transaction in which the amount was earned. Such earned income would be included with the other earned income of such person, in determining his earned income credit, and such aggregate would of course be subject to the limitations on such credit. The estate is not allowed any credit for such income which is treated as earned income in its hands, since there is no provision in Supplement E (sections 161 to 172, inclusive) allowing such a credit in the case of an estate. If the amounts are compensation for personal services rendered over a period of 36 months or more, and would be within the provisions of section 107 if the decedent had lived and included such amounts in his gross income, section 107 applies. That is, the tax attributable to the inclusion of this amount in the gross income of the person receiving it shall not exceed the aggregate of the taxes of the decedent which would be attributable to such amount if it had been received by the decedent in equal portions in each

of the months included in the period in which the personal services were rendered. Similarly, the provisions of sections 105 and 106, relating to the tax 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 tax attributable to the inclusion of this amount in the gross income of the person receiving it shall not exceed 30 percent of such amount.

§ 29.126-2 *Allowance of deductions and credit in respect of decedent.* Under section 126 (b), the expenses, interest, and taxes described in section 23 (a), (b), and (c) for which the decedent, dying in a taxable year beginning after December 31, 1942, was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid (a) as a deduction by the estate, or (b) 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 (b) above, 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 (b), 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.

However, 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.

§ 29.126-3 *Deduction for estate tax attributable to income in respect of decedent.* 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. 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 interest on bonds 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, $200 on account of the estate tax attributable to such income, computed as follows:

(a)	(1)	Value of income described in section 126 (a) (1) included in computing gross estate	$1,500
	(2)	Deductions in computing gross estate for claims representing deductions described in section 126 (b)	200
	(3)	Net value of items described in section 126 (a) (1)	1,300
(b)	(1)	Estate tax (basic and additional estate taxes, less credits against such taxes)	23,625
	(2)	Less: Estate tax computed without including $1,300 (item (a) (3) above) in gross estate	23,235
	(3)	Portion of estate tax attributable to net value of income items	23,390
(c)	(1)	Value in gross estate of income received by estate in taxable year	1,000
	(2)	Value in gross estate of all income items described in section 126 (a) (1) (item (a) (1) above	1,500
	(3)	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.

§ 29.126-4 *Income in respect of decedent dying in taxable year beginning before 1943; tax of decedent*—(a) *In general.* If the last taxable year of the decedent began before January 1, 1943, then under the law applicable to such taxable year before the enactment of the Revenue Act of 1942 all income in respect of such decedent was includible in his gross income for such taxable year, unless properly includible in gross income for a prior taxable year. See § 29.42-1. Section 134 (g) of the Revenue Act of 1942 gives the estate of the decedent and those persons entitled upon his death to receive amounts of income not includible in the income of the decedent under his method of accounting (but includible in his income under the provisions of section 42) the right to elect to have such amounts treated for tax purposes under the amendments made by the Revenue Act of 1942, that is, to exclude from the gross income of the decedent for his last taxable year any such amounts not includible therein under his method of accounting, and to include such amounts when received in the gross income of the estate and of the other persons entitled to such amounts by bequest, devise, and inheritance and by reason of the death of the decedent. The election to have these amounts treated in this manner is made by the filing of consents to such treatment by the fiduciary of the estate

and by all such persons. Section 134 (g) of the Revenue Act of 1942 provides in part as follows:

(g) *Taxable years before 1943.* In case the taxable period in which falls the date of the death of the decedent began after December 31, 1933, and before January 1, 1943, the tax for such taxable period shall be computed as if provisions corresponding to the provisions of sections 42 (a) and 43 of the Internal Revenue Code, as amended by subsections (a) and (b) of this section, were a part of the Revenue Act of 1934, the Revenue Act of 1936, the Revenue Act of 1938, or the Internal Revenue Code, whichever is applicable to such taxable period. In the case of the estate of such a decedent and of each person who acquires by reason of the death of such decedent or by bequest, devise, or inheritance from such decedent the right to receive the amount of items of gross income of the decedent which upon the application of the preceding sentence are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period, the tax for each taxable period ending on or after the date on which the decedent died shall be computed by including in gross income the amounts with respect to such decedent which would be includible, and by allowing as deductions and credits the amounts with respect to such decedent which would be allowable, if provisions corresponding to the provisions of the section inserted in the Internal Revenue Code [section 126] by subsection (e) of this section were a part of the law applicable to such taxable period. The provisions of this subsection shall not be applicable unless there are filed with the Commissioner (in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, and at the time prescribed by such regulations) signed consents made under oath by the fiduciary representing the estate and by each such person (or if any such person is no longer in existence or is under disability, by his legal representative) that with respect to such amounts the tax of the estate, or the tax of such person, as the case may be, shall be computed under the provisions of this subsection for each taxable period ending on or after the date of the death of the decedent and the tax of the decedent shall be computed under such provisions for the taxable period of the decedent in which falls the date of his death. If such consent is filed after the time for the filing of the return with respect to any such taxable period, the deficiency resulting from the failure to compute the tax for such taxable period in accordance with such consent shall be paid on the date of the filing of the consent with the Commissioner, or on the date prescribed for the payment of the tax for the taxable period, whichever is later, and the period of limitations provided in sections 275 and 276 of the Internal Revenue Code * * * on the making of assessments and the beginning of distraint or a proceeding in court for collection shall with respect to such deficiency include one year immediately after the date the consent was filed, and such assessment and collection may be made notwithstanding any provision of the internal revenue laws or any rule of law which would otherwise prevent such assessment and collection. The period within which claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, with respect to any overpayment resulting from the failure to compute the tax for any such taxable period (except the taxable period of the decedent in which falls the date of his death) in accordance with such consent shall include one year immediately after the date of the filing of the consent, and credit or refund may be allowed or made notwithstanding any provision of the internal revenue laws or any rule of law which would otherwise prevent such credit or refund, but no interest shall be allowed or paid with respect to any such overpayment. The provisions of section 322 (b) (2) and (3) of the Internal Revenue Code * * * shall not apply to the refund of any such overpayment. If the application of this subsection to the taxable period of the decedent in which falls the date of his death results in a deficiency for such taxable period, and if the income tax of the decedent for such period was deducted in computing the net estate of the decedent under Chapter 3 of the Internal Revenue Code * * * and if at the time such deficiency is assessed credit or refund of any resulting overpayment in respect of the taxes imposed by such Chapter 3 * * * upon such net estate is prevented by any provision of the internal revenue laws or by any rule of law, then the amount of such deficiency which is assessed and collected shall be reduced by the amount of such resulting overpayment under such Chapter 3 * * * which would be credited or refunded if credit or refund thereof were not so prevented. This subsection shall not be deemed to change any provision of law limiting the allowance of refund or credit with respect to overpayments for the taxable period of the decedent in which falls the date of his death, and no interest shall be allowed or paid with respect to any overpayment resulting from the application of this subsection to such taxable period. If the application of this subsection to the taxable period of the decedent in which falls the date of his death results in an overpayment for such taxable period, and if such overpayment was included as part of the income tax of the decedent which was deducted in computing the net estate of the decedent under Chapter 3 of the Internal Revenue Code * * * and if, at the time such overpayment is credited or refunded the assessment and collection of deficiencies in respect of the taxes imposed by such Chapter 3 * * * upon such net estate is prevented by any provision of the internal revenue laws or by any rule of law, then the amount of such overpayment, which is credited or refunded shall be reduced by the amount of the resulting deficiencies under such Chapter 3 * * * which would be assessable if the assessment and collection thereof were not so prevented.

(b) *Consents; tax of estate and persons filing consents.* For the purposes of the election provided by section 134 (g) of the Revenue Act of 1942, the consents must be filed by the fiduciary of the estate and by each person who received any right to income in respect of the decedent by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent. Ordinarily, the persons who must file such consents are the administrator or the executor of the estate, the residuary beneficiary of the estate, the trustees and beneficiaries of any trust the corpus of which includes such right to income, every other specific beneficiary or such right, and every person who receives any such right by survivorship, such as the surviving joint tenants of any right to income held in joint tenancy and the surviving coowners or beneficiaries of any defense bonds owned by the decedent on which there is accrued interest not includible in his gross income under his method of accounting. If any such person is not in existence or is under legal disability, the consent may be made by his legal representative.

All of such consents with respect to any one decedent shall be filed at the same time with the Commissioner of Internal Revenue, Washington, D. C. The consents must be filed not later than one year after the time prescribed for filing the return for the last taxable year of the decedent (not including any extension of time for such filing) or January 1, 1944, whichever is later.

The executor, administrator, or other fiduciary of the estate (or if there is no such fiduciary, the principal beneficiary of the estate) must submit, under oath, a statement accompanying the consents and containing the following information:

(1) A list of all the items included in the gross income of the decedent for his last taxable year which would not be includible therein if the amendments made by section 134 (a) of the Revenue Act of 1942 were applicable to the revenue law in effect for such taxable year. See § 29.42-1.

(2) The amount included in gross income with respect to each of such items, the aggregate of such amounts, the value included in the gross estate of the decedent with respect to each such item for the purposes of the estate tax, and the aggregate of such values.

(3) A list of all the items allowed as deductions and credits in computing the net income of the decedent for his last taxable year, which would not be allowable as deductions and credits if the amendments made by section 134 (b) of the Revenue Act of 1942 were applicable to the revenue law in effect for such taxable year. See § 29.43-1.

(4) The amount allowable as a deduction or credit with respect to each such item listed in (3), the aggregate of such amounts, the amount of the deductions for estate tax purposes from the gross estate of the decedent in respect of claims which are founded upon that portion of such items as are described in section 126 (b), and the aggregate of such deductions.

(5) The names and addresses of every person entitled by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent to receive any amount listed in (1).

(6) The names and addresses of every person entitled by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent to receive any property subject to an obligation of the decedent for which a deduction or credit described in § 29.126-2 is allowable.

Each consent shall be made under oath and shall contain the following:

(i) The name and address of the person filing the consent, and the collection district in which he files his return.

(ii) The name and address of the decedent, the date of his death, the period covered by his last income tax return, and the collection district in which such return was filed.

(iii) A list of all the items (at face value) of income in respect of the decedent to which the person filing the consent was entitled by request, devise, or inheritance from the decedent or by reason of the death of the decedent. If the person filing the consent is the fidu-

ciary of the estate of the decedent, the list shall set forth every item (at face value) of income in respect of the decedent acquired by the estate from the decedent. If any items listed on the consent were collected before the time the consent was filed, or if the right to receive any such items was transferred before such time to any person not entitled to such right by bequest, devise, or inheritance, or by reason of the death of the decedent, then the list must show the amount collected in respect of each such item, or its fair market value at the time it was transferred, any consideration received for the transfer, and the date of such collection or transfer.

(iv) A list of all the items in respect of the decedent for which such person may claim deductions and credits described in § 29.126-2, showing the face value of such items, the property received by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent subject to the obligation for which any such deduction is allowed, and, if any such obligation has been paid, the amount and date paid.

(v) A recomputation of the net income and of the tax of the person filing the consent, made (*a*) for each taxable year in which any item described in (ii) was collected, or in which the right to any such item was transferred to a person not entitled to such right by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent, (*b*) for each taxable year in which any item listed in (iv) was paid, or would otherwise be allowed as a deduction or credit under § 29.126-2, and (*c*) for each taxable year in which there is a carry-over or carry-back of any item from any taxable year described in (*a*) and (*b*). Such recomputation shall be made under the provisions of §§ 29.126-1, 29.126-2, and 29.126-3 by including in gross income the income in respect of the decedent which is includible under section 126 (a) and by allowing as deductions and credits the deductions and credits which are allowable under section 126 (b) and (c) when section 126 is made applicable to such taxable year and when the amendments made by section 134 (a) and (b) of the Revenue Act of 1942 are made applicable to the law in effect for the last taxable year of the decedent (see §§ 29.42-1 and 29.43-1). This recomputation shall be made only for taxable years the returns for which were due prior to the date the consent is filed. The increase or decrease in tax for each such taxable year as a result of such recomputation shall be shown, as well as the aggregate of such increases and the aggregate of such decreases.

(vi) An unqualified statement by the person filing the consent agreeing that his tax for each taxable year ending on or after the date the decedent died and the tax of the decedent for his last taxable year shall be computed under the provisions of section 134 (g) of the Revenue Act of 1942.

A payment equal to the excess of the aggregate of the increases over the aggregate of the decreases in tax set out in (e) on the consent must accompany the filing of the consent. The period of limitations for assessing or collecting the increase in tax upon such recomputation for each such previous year includes one year immediately after the filing of the consents, and such assessment and collection may be made whether or not any period of limitation or any rule of law (such as a previous judicial determination of the tax liability for such year) would otherwise prevent such collection or assessment. Interest on the increase in tax for each previous taxable year is measured from the date prescribed by law for the payment of the tax for such previous taxable year. If the aggregate of the decreases in tax exceeds the aggregate of the increases in tax, the taxpayer may file claim for credit or refund of such excess, and the period of limitation for filing such claim includes one year immediately after the filing of the consents. Such credit or refund may be made whether or not any period of limitations or any rule of law would otherwise prevent such credit or refund. The amount of such credit or refund will not be limited by section 322 (b) (2) or (3). No interest will be allowed with respect to any such credit or refund.

The person filing his consent must compute his tax for each taxable year, the return for which is due on or after the date the consent is filed, under the provisions of section 126 as if the amendments made by section 134 (a) and (b) were effective with respect to the revenue law applicable to the taxable year in which the decedent died. See §§ 29.42-1, 29.43-1, 29.126-1, 29.126-2, and 29.126-3. See also §§ 19.42-1 and 19.43-1 of this chapter, and paragraph 8 of Treasury Decision 5233, approved February 26, 1943.[1]

(c) *Tax for last taxable year of decedent if consents filed.* If the consents described in paragraph (b) of this section are properly filed, the tax of the decedent for his last taxable year is computed as if the amendments made by section 134 (a) and (b) of the Revenue Act of 1942 were applicable to the revenue law in effect for such taxable year of the decedent. See §§ 29.42-1 and 29.43-1. However, no interest shall be allowed with respect to any credit or refund of any overpayment for such taxable year resulting from the application of these amendments. Furthermore, credit or refund of any such overpayment is only allowed subject to the provisions of section 322, and nothing in section 134 of the Revenue Act of 1942 makes any change in any provision of law which limits the allowance of credit or refund of an overpayment for the last taxable year of the decedent. Thus, if the claim for the credit or refund of an overpayment, caused by the application of section 134 (g) of the Revenue Act of 1942, is not filed within three years after the return for the last taxable year of the decedent was filed or two years after the last payment of tax for such taxable year was made, then no refund is allowable. If the claim is filed within such period, the refund which may be made must not exceed the portion of the tax paid within the period, preceding the filing of the claim for credit or refund, prescribed by section 322 (b) (2).

In cases in which the decedent had more deductions subject to the amendment made by section 134 (b) of the Revenue Act of 1942 than income subject to the amendment made by section 134 (a) of such Revenue Act, a deficiency for his last taxable year may result from the retroactive application of such amendments under section 134 (g) of that Act. Since the estate and the beneficiaries, in the filed consents, agree to the redetermination of the tax of the decedent for his last taxable year, such tax will be assessed and collected notwithstanding the prior running of any period of limitations or any other rule of law which would otherwise bar such assessment and collection.

Since the income tax of the decedent for his last taxable year was deductible as a claim against his estate in determining the estate tax, any overpayment of income tax for his last taxable year may have been an improper deduction from his gross estate. Therefore, if any such overpayment is determined for such taxable year by reason of the application of section 134 of the Revenue Act of 1942, the estate tax must then be recomputed by disallowing any deduction of such overpayment of income tax, and upon this recomputation a deficiency in estate taxes may be determined. If at the time any credit or refund of such overpayment in income tax is allowed or made, the assessment and collection of the deficiency in estate taxes are barred by any provision of the internal revenue laws or by any rule of law, then the amount of such deficiency in estate taxes is deducted from the amount which would otherwise be refunded or credited.

Similarly, if there was a deficiency in income tax for the last taxable year of the decedent, by reason of the application of section 134 (g) of the Revenue Act of 1942, then the deduction for income tax of the decedent in computing his net estate for estate tax purposes may have been too small, and an overpayment of estate taxes may have resulted. If credit or refund of this overpayment is barred at the time the deficiency in income taxes is assessed, the amount of the deficiency in income taxes shall be reduced by the amount of any such overpayment in estate taxes.

SEC. 127. WAR LOSSES [as added by sec. 156 (a), Rev. Act 1942].

(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.

[1] 8 F.R. 2554.

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.

§ 29.127 (a)-1 *Description of war losses.* Under section 127, property destroyed or seized in the course of the present war and property which is within an enemy country or an enemy controlled area on the date the United States declares that a state of war exists with the enemy country result in war losses. Property which is within an area that comes under the control of an enemy country after the date the United States declares that a state of war exists with such enemy country also results in a war loss. An investment in any of the foregoing property which loses all its value because of the war loss resulting from such property is itself treated as resulting in a war loss. Investments in such property which lose only part of their value by reason of such property resulting in a war loss are also treated, under certain circumstances, as resulting in a war loss to the extent of such loss in value. See section 127 (e).

Section 127 (a) and (e) provides that the property and investments described above shall be treated as being "destroyed or seized" upon the date specified in the applicable subsections. That is, upon such date the taxpayer is treated as losing his entire interest in such property or investment, and this loss of such property rights is deemed to be sustained by reason of a casualty. The casualty is the destruction or seizure, whichever event the taxpayer claims occurred. If the property or investment was held for more than six months and was a capital asset or property used in the trade or business of the taxpayer, this loss (and any compensation therefor) is subject to the provisions of section 117 (j), relating to gains and losses upon involuntary conversions. See § 29.117-7. Unless such loss is treated under section 117 (j) as a loss from the sale or exchange of a capital asset, such loss is deductible as an ordinary loss under the provisions of section 23 (f) in the case of a corporation and section 23 (e) (3) in the case of an individual. The loss upon an investment which is treated under section 127 as resulting in a war loss is not subject to the provisions of section 23 (g) (2) and (k) (2) which treat losses upon worthless securities as capital losses, although such loss may nevertheless be treated under section 117 (j) as a loss upon the sale or exchange of a capital asset.

For property to be treated as resulting in a war loss, such property must be in existence on the date prescribed in section 127 (a) (2) as the date it is deemed destroyed or seized or at the beginning of the period prescribed in section 127 (a) (1) or (a) (3), within which period the property is deemed destroyed or seized, and for the taxpayer to claim a loss with respect to such property he must own such property or an interest therein at such time. If, before such time, the property was destroyed or confiscated, section 127 is not applicable with respect to such property. For example, a taxpayer owned property in an enemy country before war was declared on such enemy by the United States, and such property was confiscated by the enemy before the date war was declared. The seizure was not in the course of military or naval activities. The taxpayer may not claim a war loss with respect to such property under section 127.

For the purposes of section 127, the term "area" does not mean a territory or political unit but means the locality in which the property was situated.

The date on which a war loss was sustained must be determined under the provisions of section 127 (a) and the regulations thereunder. The amount of loss sustained must be determined subject to the provisions of section 127 (b) and the regulations thereunder. Income to the taxpayer upon any recovery of or in respect of property or investments treated as resulting in a war loss must be determined under section 127 (c) and the regulations thereunder. The basis of any such recovery must be determined under section 127 (d) and the regulations thereunder.

§ 29.127 (a)-2 *Property destroyed or seized after the outbreak of war.* Section 127 (a) (1) has two main purposes. One is to provide that property shall be treated as destroyed or seized if it is located in an area which comes under the control of an enemy country after the date the United States declares that a state of war exists with such enemy country. This provision corresponds to the provisions of section 127 (a) (2) which give similar treatment to property located in an area under enemy control on the date the United States declares that a state of war exists with the enemy. See § 29.127 (a)-3. The other purpose of section 127 (a) (1) is to provide the method for determining the date on which such destruction or seizure is deemed to occur in cases in which the exact date when control is established cannot be determined, and to provide the method for determining the date of destruction or seizure in the case of property actually destroyed or seized in the course of military or naval operations by any country engaged in the present war if the exact date of such destruction or seizure cannot be established.

(a) *Actual destruction or seizure.* Any property actually destroyed or seized 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 any date chosen by the taxpayer which falls between:

(1) The latest date, as established to the satisfaction of the Commissioner, on which such property may be considered as not destroyed or seized, and

(2) 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.

If the exact date of the destruction or seizure can be ascertained, then (1) refers to the day before such date and (2) refers to the day after such date. Thus, if the taxpayer knows that his property was destroyed during a bombing raid on London on January 7, 1942, the latest date on which such property may be considered as not destroyed is January 6, 1942, and the earliest date on which it may be considered as being already destroyed is January 8, 1942. Under section 127 (a) (1), the only date the taxpayer may choose is January 7, 1942. However, in many cases the taxpayer will not be able to ascertain the exact date on which the destruction or seizure of his property occurred. In such cases the taxpayer may claim that the destruction or seizure occurred at any time he

chooses between the dates prescribed in (1) and (2) of this paragraph, which dates may be established on the basis of such information as the taxpayer is reasonably able to obtain. For example, the taxpayer's property was destroyed during a bombardment of a certain area which lasted several days. The taxpayer is only able to ascertain that the property was undestroyed before the bombardment, and was already destroyed when the bombardment ended. The taxpayer may treat the destruction as occurring on any date during the bombardment.

Section 127 (a) (1) refers to a destruction or seizure by the United States or any other country engaged in the present war. Such other countries are the members of the United Nations, any other countries at war with enemies of the United States, and the enemies of the United States or of any of the United Nations. Thus, a country which is not a member of the United Nations nor an enemy of the United States is nevertheless considered engaged in the present war if it is an enemy of any other member of the United Nations. Furthermore, the military or naval operations need not be carried on by the regular forces of the countries engaged in the present war, but it is sufficient if such operations are carried on by any forces supported by or operating in conjunction with any such country. For example, nationals of the D country form an independent fighting force for the liberation of their country, which was conquered by an enemy of the United States, and such fighting force operates in conjunction with the forces of one or more of the United Nations. The military or naval operations of such force are considered for the purposes of section 127 (a) (1) as military or naval operations by the countries, engaged in the present war, with which such forces operate.

The term "military or naval operations" in section 127 (a) (1) is used in a broad sense to cover all actions incident to belligerent activities, whether in furtherance of or in opposition to such activities. It includes operations carrying out a scorched earth policy or rendering a position under threat of attack or other danger more secure or less desirable to the attacker. For example, when invasion of a certain area by the forces of an enemy is imminent, civilians in such area burn and otherwise destroy warehouses and other property in such area. Such property is destroyed in the course of military or naval operations of the enemy. However, the orderly requisition or condemnation of property by any government, in the ordinary course of which the taxpayer is entitled to fair compensation, is not a destruction or seizure in the course of military or naval operations.

(b) *Property deemed destroyed or seized by reason of enemy control.* Property in an area which, after the date the United States declares war with a country, comes under the control of such enemy country is deemed to have been seized or destroyed in the course of military or naval operations by such country. Such destruction or seizure is deemed to occur on any date chosen by the taxpayer which falls between the latest date, as determined by the Commissioner, on which the area was under the control of the United States or a country not at war with the United States, and the earliest date, as determined by the Commissioner, on which the area was under the control of the enemy country.

If during the period described in the above paragraph the property in such area was actually destroyed or seized in the course of military or naval operations by any country engaged in the present war, the taxpayer may choose as the date on which the destruction or seizure occurred any date falling after whichever of the following dates is the earlier:

(1) The latest date, as established to the satisfaction of the Commissioner, on which such property may be considered as not destroyed or seized, or

(2) 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 falling before whichever of the following dates is the earlier:

(i) 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, or

(ii) 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.

For example, the taxpayer has property in an area under the control of a country not at war with the United States. Such country lost control of the area on December 20, 1942, under attack by the enemy, but the taxpayer who remained in the area ascertains that the property was not destroyed on that date, but was destroyed during further fighting on January 1, 1943. An enemy country gained control of the area on February 1, 1943. The earliest date on which the taxpayer may claim the loss is December 20, 1942, the day after the latest date on which the area was under control of a country not at war with the United States. The latest date on which it may claim the loss is January 1, 1943, the day before the earliest date on which the property may be considered as having already been destroyed. An additional example is the case of a taxpayer with property in an area evacuated on December 15, 1942, when a country not at war with the United States lost control of such area. The property of the taxpayer in such area was undestroyed on such date. An enemy country established control over the area on January 21, 1943. The taxpayer learns that on July 15, 1943, the property was destroyed in a bombing raid on such area. The loss may not be claimed as occurring on any date later than January 20, 1943, the day before the earliest date on which the enemy country was in control of the area.

Whether or not a country at war with the United States gains control over intangible property by reason of its gaining control over any area is determined under the same provisions as are applicable for the purposes of section 127 (a) (2) in determining whether intangible property is subject to the control of the enemy country on the date war is declared. See § 29.127 (a)-3.

In the case of any property which is within the provisions of section 127 (a) (1) by reason of any area falling under the control of an enemy of the United States, it is necessary to determine the latest date on which the United States or any country not at war with the United States was in control of such area and the earliest date on which the country at war with the United States was in control of such area. For the purposes of section 127 (a) (1), control of an area on any day means effective control which is not seriously disputed at any time during such day. For such control to exist, order must be maintained in the area, such order must be maintained by authority of the country in control, and such order must not be seriously disputed by hostile action either by elements of the civilian population or by the armed forces of any other country. Section 127 (a) (1) contemplates that in many cases there will be a lapse of time between the date when one country loses control of an area and the date when another country gains control. During this period neither country will be in control of the area, and the loss may be claimed to occur at any time during such period. The fact that any country loses control of an area is not sufficient for the purposes of section 127 (a) (1) unless a country at war with the United States gains control of such area. That is, if a country not at war with the United States, which has lost control of an area, regains control of the area before a country at war with the United States gains control, the fact that control was lost for a period of time does not cause any property in the area to be deemed to have been destroyed or seized.

It should be noted that the term "area" means the locality in which the property is situated. The determination as to whether control by any country was lost or established in any area on any date will be made in a practical manner on the basis of all factors, and particular attention will be paid to the nature of the military and political operations affecting the control over such area as well as to the amount of information which can be obtained under the circumstances. For example, in view of the fact that the island of Luzon was one theater of military operations, complete control over such island by the American and Philippine forces will be considered to have ceased in December 1941, upon the beginning of the Japanese invasion of the island, and complete Japanese control will be considered to have begun in May 1942, upon the cessation of American resistance at Corregidor. In the absence of information to the contrary, control by American and Philippine forces over other Philippine islands will be considered to have ceased on the date in December 1941 when complete control of

Luzon ceased, and Japanese control over such other islands will be considered to have begun on the date in May 1942 when complete Japanese control of Luzon began. Similarly, control over areas in other theaters of military or political action will be determined on the basis of the principal events in such theaters of action.

A country at war with the United States may gain control over an area by its armed forces, by its civil authorities, or by obtaining control over the local authorities already established in that area. Such control over local authorities will not be deemed to exist by reason of the enemy country's domination over the government of any country if and so long as the United States maintains diplomatic relations with such government. Areas formerly subject to such government but actually taken over by armed forces or civil authorities of the enemy country are under the control of the enemy country. If the United States has not declared that a state of war exists with any country, the control by such country over any area is not deemed a destruction or seizure of property in such area, even though such country may be considered engaged in the present war by reason of its being an enemy of one of the United Nations.

The latest date on which the United States or a country not at war with the United States was in control of an area, and the earliest date when an enemy of the United States was in control of an area, are questions of fact to be determined by the Commissioner on the basis of the facts established by the taxpayer and such other information as may be in his possession. The Commissioner may from time to time issue rulings on the basis of all information then in his possession as to such dates as he has already determined, with respect to any areas. Such rulings will be subject to change in the event further information is obtained. In the absence of any applicable ruling, the facts established by the taxpayer must satisfy the Commissioner that the dates chosen are proper.

(c) *Choice of date when loss deemed sustained.* Section 127 (a) (1) grants the taxpayer the right to choose within the period described in paragraphs (a) and (b) of this section the date on which the destruction or seizure of property is deemed to occur. This choice of a date is exercised by claiming a gain or loss with respect to such destruction or seizure in a return for a taxable year in which such date falls, in a claim for credit or refund of an overpayment for such taxable year, or in a petition to The Tax Court of the United States with respect to such taxable year. Until the taxpayer makes such a choice upon a return, a claim, or a petition, he will be deemed to have chosen the latest date on which the destruction or seizure may be treated as having occurred. Such latest date will be considered for all purposes the date chosen by the taxpayer if the taxpayer has not chosen on a return, claim, or petition, in the manner described above, any other date by the time the return for the period in which such latest date falls is due (including any extension of time for filing such return). Thereafter, the taxpayer may choose another date only with the permission of the Commissioner. If the taxpayer has once made the choice described above by the filing of a return, a claim, or a petition in which gain or loss is claimed with respect to the destruction or seizure, such choice (whether made before or after the enactment of the Revenue Act of 1942) may not thereafter be changed except with the permission of the Commissioner.

A taxpayer desiring to make a new choice of date with the permission of the Commissioner shall send a copy of his return, claim for refund, or petition in which he makes such new choice to the Commissioner of Internal Revenue, Washington, D. C., together with a statement of the date previously used as the date of the destruction or seizure, the new date chosen, and a recomputation of each tax imposed by the Internal Revenue Code (including income, excess profits, and declared value excess profits taxes) for each taxable year affected by such change of date. For example, if the taxpayer on the calendar year basis desires to change his choice of date from a date in 1942 to one in 1943, and if there was a carry-back of unused excess profits credit from 1942 to 1941, the taxpayer must attach to his request for permission to change his choice of date a recomputation of the tax for 1943, reflecting the tax effect of treating the destruction or seizure as occurring in that year, for 1942, reflecting the effect of treating the destruction or seizure as not occurring in such year, and for 1941, computed with the carry-back from 1942 determined by treating the destruction or seizure as occurring in 1943 and not 1942.

The taxpayer must also attach to his request a statement as to whether the tax for any taxable year affected by the change of date has been determined by The Tax Court of the United States or by any court, whether a case with respect to any such tax liability is pending in any such tribunal, and whether any period of limitations or rule of law would prevent the proper adjustment of the tax liability for each such year if the change in date were permitted. The Commissioner will permit the taxpayer to change his choice of the date of the destruction or seizure if such proper adjustments may be made, for each taxable year affected.

§ 29.127 (a)-3 *Property in enemy countries and enemy controlled areas.* Property in a country at war with the United States, or in an area controlled by such country, on the date the United States declared that a state of war existed with such country is deemed under section 127 (a) (2) to have been destroyed or seized on such date.

The term "property" includes tangible property of every kind actually within such country or area. Whether or not intangible property is within the provisions of section 127 (a) (2) depends in general upon whether the enemy country exercises the same control over such intangible property as it exercises over tangible property located within such country or area. If the enemy country may legally divest the taxpayer of his right to such intangible property in such manner that all other jurisdictions having control of any of the obligations and assets from which such intangible property derives its value would not recognize the taxpayer as having any interest in such obligations and assets, then such intangible property is within the provisions of section 127 (a) (2) For example, a taxpayer owns stock and bonds in a corporation chartered by an enemy country. All of the assets of such corporation are in the enemy country, in a neutral country, and in a country also at war with the enemy country. The enemy country may sequester the taxpayer's interest in such stock and bonds. The neutral country recognizes the control of the enemy country over its corporation, and would not grant the taxpayer any right of recourse against the assets of the corporation located in such country. The country at war with the enemy country treats the assets of the corporation located within its jurisdiction as enemy property and would grant the taxpayer no rights in such assets during the war. The stock and bonds of the taxpayer are property within the enemy country and subject to the provisions of section 127 (a) (2) A further example is the case of a taxpayer having negotiable bonds in a corporation chartered in a neutral country. Such bonds are in the enemy country at the outbreak of the war, in the hands of an agent of the taxpayer. The neutral country does not recognize the authority of the enemy country to divest the taxpayer of his right to these bonds. Such bonds are not property subject to the provisions of section 127 (a) (2)

Ordinarily, if the right of the taxpayer to the intangible property exists by reason of the law and authority of the enemy country, section 127 (a) (2) applies to such intangible property. For example, all public bonds of a country at war with the United States are considered to be within the provisions of section 127 (a) (2) On the other hand, the public bonds of a country not at war with the United States, the territory of which is occupied by a country at war with the United States on the date war is declared, are not within the provisions of section 127 (a) (2) Any interest in a corporation chartered by a country at war with the United States will be considered intangible property located in the enemy country unless the taxpayer has any rights to assets of such corporation not treated as destroyed or seized under section 127. However, any interest in a corporation chartered by a country not at war with the United States, the territory of which is occupied by a country at war with the United States, will not be considered intangible property located in an area under the control of an enemy country. Any intangible property not within the provisions of section 127 (a) (2) may be within the provisions of section 127 (a) (3) which relate to intangible property which becomes worthless by reason of war losses. See § 29.127 (a)-4.

For the purposes of section 127 (a) (2), the control by the enemy country

over any area may be exercised either through its military or civil agencies, or through its control over the local authorities. Thus, an area will be treated as being under the control of the enemy country if the enemy country exercises its control through the agents of a puppet government or through the local governmental organization in operation at the time it gained control of the area. Such control over local authorities will not be deemed to exist by reason of the enemy country's domination over the government of any country if the United States maintains diplomatic relations with such government. Areas formerly subject to such government but actually taken over by armed forces or civil authorities of the enemy country are under the control of the enemy country. Areas under the control of the governments of Hungary, Rumania, and Bulgaria will not be considered under enemy control prior to the date the United States declared that a state of war existed with such governments. Whether or not control by the enemy country exists is a question of fact which the Commissioner will determine on the basis of the facts established by the taxpayer and such other facts as may be in his possession.

§ 29.127 (a)-4 *Investments referable to destroyed or seized property.* Section 127 (a) (3) provides that intangible property which is an interest in or with respect to underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) shall itself be treated as being destroyed or seized if it would be worthless if such underlying assets had in fact been destroyed. The intangible property may be of any kind, provided it meets the test that it would become worthless upon the actual destruction of the underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) Thus, it may be represented by accounts receivable from or by stocks, bonds, or other securities in a corporation all of the assets of which are treated as destroyed or seized under section 127 (a) (1) or (2) or by obligations of an individual, under the control of an enemy country, all of whose assets are also under the control of the enemy country. Any intangible property which derives its value from underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) is considered an interest in or with respect to such assets for the purposes of section 127 (a) (3) For example, if all of the assets owned by a holding company are securities within the provisions of section 127 (a) (3) as being issued by corporations owning only property described in section 127 (a) (1) and (2) then stock in such holding company is considered an interest in or with respect to such property described in section 127 (a) (1) and (2) and is subject to the provisions of section 127 (a) (3).

For intangible property to be treated as destroyed or seized under section 127 (a) (3) the following tests must be met:

(a) Such property must be worthless if the value described in the next paragraph is disregarded; and

(b) Such property must be of a kind which would have become worthless upon the destruction of all the underlying assets which are described in section 127 (a) (1) and (2) That is, upon the date the last underlying asset described in section 127 (a) (1) or (2) is deemed destroyed or seized, there must be no other underlying asset from which such property derives a value. In applying this test as to whether the intangible property would have become worthless if the underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) were actually destroyed, all interest in such assets shall be considered to have ceased as if such assets had been totally destroyed, whether or not any such asset, such as land, may ordinarily be considered indestructible. Furthermore, the value described in the next paragraph is disregarded in determining whether such property would have become worthless.

In determining for the purposes of both (a) and (b) whether property has become worthless, any value attributable to the possibility of recovering assets treated as destroyed or seized under section 127 (a) (1) and (2) or of compensation (other than insurance or similar indemnity) for their destruction or seizure, such as an award by a government upon the completion of the war, shall be disregarded. Insurance or any other certain indemnity by a government is not disregarded. For the purposes of (a) any value attributable to an actual recovery in the taxable year in which the loss is claimed or, if the possibility of receiving compensation develops during such taxable year into a recognized right to compensation, attributable to such right to compensation, will prevent the intangible property from becoming worthless, and will therefore keep such property from being treated as a war loss under section 127 (a) (3)

Whether or not intangible property is worthless when the underlying assets described in section 127 (a) (1) and (2) are treated as destroyed or seized is a question of fact to be established by the taxpayer. Thus, the intangible property may be worthless even though there are underlying assets which are not treated as destroyed or seized under section 127 (a) (1) and (2) if it derives no value from such other assets, as in a case in which there are obligations actually enforceable against such assets which are superior to the interest in such assets represented by the intangible property. For example, a corporation has $100,000 of assets, $80,000 of which are treated as destroyed or seized under section 127 (a) (1) and (2) and $20,000 of which are located in the United States and are not within the provisions of section 127 (a) (1) and (2) The corporation owes considerably more than $20,000 to creditors in the United States. Any stock interest in such corporation is considered worthless. If the corporation owed only $10,000 to creditors who could enforce their claims against the corporation, and owed $40,000 to creditors who are alien enemies of the United States, located in countries at war with the United States, who could not enforce their claims against the corporation, the stock is not considered worthless. The fact that any underlying assets, not under the control of a country at war with the United States, are subject to stringent controls by the United States or by any other government, such as being placed in blocked accounts or under "freezing" controls, or otherwise under the custody of the government, will not cause any interest in such assets to be considered worthless. Such assets are merely subject to government regulation, and the interest in or with respect to such assets continues subject to such regulation.

The intangible property interest described in section 127 (a) (3) is deemed to be destroyed or seized upon the date that the last of the underlying assets subject to the provisions of section 127 (a) (1) or (2) was treated as destroyed or seized under that section. In determining for such purposes when any property described in section 127 (a) (1) was destroyed or seized, the taxpayer may choose any date described in that section which he could properly choose under that section if he were the owner of such property. The choice is made by the taxpayer's claiming a loss with respect to the destruction or seizure of the intangible property described in section 127 (a) (3) in a return for the taxable year in which the date chosen falls, or in a claim for credit or refund of an overpayment for such taxable year, or in a petition to The Tax Court of the United States with respect to such taxable year. If no such choice is made, the date chosen will be deemed to be the latest date which could be chosen under section 127 (a) (1). If at the time the return for the taxable year in which such latest date falls is due (including any extension of time for filing such return), the taxpayer has not so chosen a date in a return, claim for refund, or petition, such latest date will be considered for all purposes the date chosen, and the taxpayer may not later choose any other date unless he first obtains the permission of the Commissioner. A taxpayer choosing a date by claiming such a loss on a return, claim for refund, or petition (whether or not such choice was made before the enactment of the Revenue Act of 1942) cannot change such choice unless he obtains the permission of the Commissioner. A taxpayer requesting the permission of the Commissioner in order to choose a new date must submit the same information as is required under § 29.127 (a)-2 (c) in the case of a taxpayer changing his choice of date under section 127 (a) (1), and such permission will be granted if the proper adjustments in tax liability resulting from such change may be made. The choice of date by the taxpayer must be the same for all intangible property which relates to the same property treated as destroyed or seized under section 127 (a) (1) and (2). Thus, a taxpayer owning stock and bonds in a corporation, all the assets of which are in an area that comes under the control of the enemy, cannot under section 127 (a) (3) treat the stock as destroyed or seized on one date and the

bonds as destroyed or seized on another date.

If a taxpayer owns 100 percent (excluding qualifying shares) of each class of stock of a corporation, it may elect for the purposes of section 127 (a) (3) to determine the worthlessness of its interest in such corporation without regard to the amount of the property of such corporation which is 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 any of such property of the corporation which is treated as destroyed or seized under section 127 (a) (1) (2) or (3) during or before the taxable year of the taxpayer in which the war loss is claimed. This exclusion of certain property of the corporation in determining worthlessness is made both for the purpose of determining whether the interest of the taxpayer in the corporation is worthless and for the purpose of determining whether such interest would have become worthless if the underlying assets of the corporation treated as destroyed or seized under section 127 (a) (1) or (2) had been destroyed. Such election is made by claiming in a return, a claim for credit or refund of an overpayment, or a petition to The Tax Court of the United States a deduction for a loss which was actually sustained upon the destruction or seizure described in section 127 (a) (3) of any interest in such corporation. The election is made for the entire interest of the taxpayer in the corporation, whether represented by stock, bonds, or otherwise, and is so made even if the taxpayer claims the loss for only a part of such interest. Such election when once made is irrevocable, although the date chosen as the date when the loss occurred may be changed with the permission of the Commissioner as in the case of other losses from a destruction or seizure described in section 127 (a) (3) For treatment of the amount of property excluded in determining worthlessness as a recovery by the taxpayer, see § 29.127 (b)-1.

For a loss to be sustained under section 127 (a) (3) with respect to any intangible property, such property must have a basis. Any intangible property treated as destroyed or seized under section 127 (a) (3) will, to the extent of the loss sustained upon such destruction or seizure, be treated as a casualty loss. Section 23 (g) (2) and (k) (2) relating to losses on certain worthless securities being treated as capital losses, does not apply to the loss on any such intangible property described in section 127 (a) (3) although such loss may, if the provisions of section 117 (j) are applicable, be treated as a capital loss under the provisions of section 117 (j) See § 29.117-7.

[SEC. 127. WAR LOSSES—as added by sec. 156 (a), Rev. Act 1942.]

(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.

§ 29.127 (b)-1 *Determination of amount of war loss.* The loss upon the property treated as destroyed or seized under section 127 (a) and (e) is determined as if the taxpayer's interest in such property had ceased by reason of such destruction or seizure. The loss is determined in the same manner as in the case of any other loss by casualty (see §§ 29.23 (e)-1 and 29.23 (f)-1 except that the possibility of recovering such property described in section 127 (a) or (e) or of recovering 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 (such as the return of the property, or an award by a government, upon the termination of the war) is disregarded both in determining whether the loss is evidenced by a closed and completed transaction and in determining the amount of the loss. Insurance or any other certain indemnity by a government is not disregarded. If during the same taxable year in which the destruction or seizure is deemed to occur the taxpayer recovers the property, recovers money or other property in lieu of such property, or receives compensation for such property, or if during such taxable year the possibility of any such recovery or of receiving any such compensation develops into a recognized right to such recovery or compensation, such facts must be taken into account in determining whether any loss was sustained and, if a loss was sustained, the amount of the loss. For example, the taxpayer has property in an area under the control of an enemy country on the date war with such country is declared. Such property is deemed, under section 127 (a) (2) destroyed or seized on such date. During the taxable year of the taxpayer in which such date falls, the property is sent into a neutral country where the taxpayer recovers it. No loss is sustained by the taxpayer by reason of the destruction or seizure deemed to occur under section 127 (a) (2) If in lieu of such property the taxpayer had recovered other property in the same taxable year, the value of such other property must be taken into account as compensation for the loss sustained upon the destruction or seizure deemed to occur under section 127 (a) (2)

If a taxpayer owning 100 percent of each class of stock of a corporation elects under section 127 (a) (3) (see § 29.127 (a)-4) to determine the worthlessness of his interest in such corporation without regard to certain assets of the corporation as described in section 127 (a) (3), the entire value of such assets of the corporation as of the date the taxpayer's interest in the corporation is deemed destroyed or seized under section 127 (a) (3) shall be treated as a recovery on such date by the taxpayer in determining the amount of his loss upon such destruction or seizure. Obligations of the corporation enforceable against such assets are disregarded in determining the amount of such recovery. For example, if the corporation's interest in such assets is worth $100,000, the taxpayer's recovery under the provisions of section 127 (a) (3) is considered to be $100,000, regardless of whether or not any obligations of the corporation, enforceable against such assets, are superior to the interest of the taxpayer in the corporation. Thus, if the only interest of the taxpayer in the corporation is his ownership of its stock, and if the adjusted basis of such stock is $1,000,000, his loss is $900,000 even though the corporation may have $300,000 in outstanding bonds enforceable against such assets of $100,000 and against its other assets which were not treated as destroyed or seized under section 127. (It is assumed that the stock would not be worthless, and therefore a war loss under section 127 (a) (3) if the election under section 127 (a) (3) were not made.)

If, in the same taxable year in which the destruction or seizure of any property is deemed to occur, such property was used to discharge or satisfy any obligations and liabilities of the taxpayer, or if any such obligations and liabilities are discharged by reason of the events which cause such property to be treated as destroyed or seized, the amount of such compensation must be taken into account in determining the loss upon the destruction or seizure of the property. Furthermore, the taxpayer may elect to decrease the amount of his loss in the taxable year with respect to any property treated as seized or destroyed under section 127 by the amount of his other obligations and liabilities with respect to such property if such obligations or liabilities are discharged or satisfied in a subsequent taxable year out of such property or if the taxpayer is unable to determine at the time of the election whether or not such obligations or liabilities are so discharged or satisfied. The determination of the amount of the loss where there are obligations and liabilities with respect to destroyed or seized property is illustrated by the case of a bank having a branch in Rumania, the assets of which are treated under sec-

tion 127 (a) (2) as destroyed or seized on the date war is declared with Rumania. In determining the loss upon such assets, consideration must be given to the compensation for the destruction or seizure resulting from the assets being used in the same taxable year to discharge the bank's liabilities to depositors in the branch. Furthermore, if the bank establishes that any liabilities to depositors were discharged out of the assets in a subsequent taxable year, or if the bank establishes that it is unable to determine whether or not any such liabilities are discharged out of the assets, it may elect to decrease the amount of the loss with respect to the assets in the branch by all such liabilities. If it is determined that any liabilities will not be discharged out of the assets, the bank may not decrease the amount of the loss by the amount of such liabilities.

The election described above to decrease the amount of the loss by obligations and liabilities with respect to the destroyed or seized property is made by so decreasing the loss in claiming a deduction therefor in the return (or if such return was filed on or before March 15, 1943, in an amendment thereto filed on or before July 1, 1943) 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 the taxable year in which the loss was sustained, and by attaching to such return (or such amendment thereto filed on or before July 1, 1943) as a part thereof, or by including in such claim a statement as to the obligations and liabilities involved, the property to which they relate, and such facts as are in the taxpayer's knowledge. If the loss is claimed in a petition to The Tax Court, such statement, made under oath, should be attached to a copy of the petition and sent to the Commissioner of Internal Revenue, Washington, D. C. The election when once made may be changed only with the permission of the Commissioner. The election must be made as to all the obligations and liabilities described above with respect to the same property, and applies to all such obligations and liabilities if made as to any of them.

[SEC. 127. WAR LOSSES—as added by sec. 156 (a), Rev. Act 1942.]

(c) *Recoveries included in gross income*—(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).

(2) *Amount of gain includible.* The amount of the recovery of any money or property in respect of property considered under subsection (a) as destroyed or seized 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. To the extent that such amount 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, 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 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, 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. 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 of the taxpayer under this chapter.

(3) *Restoration of value of investments referable to destroyed or seized property.* For the purposes of paragraphs (1) and (2), 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.

§ 29.127 (c)-1 *Recoveries included in gross income.* A taxpayer who has sustained a war loss described in section 127 must include in his gross income for each taxable year, to the extent provided in section 127 (c) 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) 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. See § 29.127 (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 his allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1. 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 § 29.112 (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 § 29.117-7.

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. 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 purposes of section 127 (c) Similarly, if a taxpayer who sustained a war loss under section 127 (e) 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) 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)

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:

(a) 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 of the Internal Revenue Code, as determined under

§ 29.127 (f)-1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(b) The amount of the recoveries for any day which is not excluded from gross income under (a) 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, if any, of the amount of the recoveries for such day which is not included in gross income under (a)

(c) The amount of the recoveries for any day which is not excluded from gross income under (a) and is not included in gross income as ordinary income under (b) 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:

(1) 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.

(2) 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.

(3) 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 purposes, 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.

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 § 29.127 (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, or $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 related 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).

For the purposes 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 § 29.127 (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.

[Sec. 127. War losses—as added by sec. 156 (a), Rev. Act 1942.]

(d) *Basis of recovered property.* The unadjusted basis of property recovered in respect of property considered 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 (determined under the preceding sentence) or 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 Commissioner may determine under regulations prescribed by him with the approval of the Secretary, 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.

§ 29.127 (d)-1 *Basis of recovered property.* Under section 127 (d) 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:

(a) 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 § 29.127 (c)-1.

(b) Such fair market value, as reduced under (a) above, 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 § 29.127 (c)-1.

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 § 29.127 (c)-1.

If the respective bases of several properties of a taxpayer determined under section 127 (d) are greatly disproportionate to their adjusted bases immediately prior to their being treated as destroyed or seized 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 prior to 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 the preceding paragraph.

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 prior to 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 prior to 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 the first paragraph of this section 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.

The amount of any adjustments to the unadjusted basis determined under the first paragraph of this section 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 the first paragraph of this section, 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.

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.

[SEC. 127. WAR LOSSES—as added by sec. 156 (a), Rev. Act 1942.]

(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.

§ 29.127 (e)-1 *Cases in which liquidation of corporation causes war loss.* Section 127 (e) provides that in a limited class of cases a portion of the loss by a taxpayer upon the liquidation of a corporation will be treated as a war loss resulting from the destruction or seizure of an allocable part of the interest of the taxpayer in the corporation. The war loss is sustained at the time the loss upon the liquidation is sustained. The taxpayer sustains a war loss only if section 127 (e) applies to the loss sustained by him upon the liquidation of the corporation, and only in the amount determined under that section. The provisions of section 127 (b) (c) and (d) and the regulations thereunder, which apply to a war loss determined under section 127 (a) (3) also apply to a war loss determined under section 127 (e)

(a) *Application of section* 127 (e) Section 127 (e) applies only if all of the following provisions are met:

(1) The taxpayer must own not less than 50 percent of each class of stock of the corporation at the time of the liquidation described below and at all times when any property of the corporation described in section 127 (a) is deemed destroyed or seized.

(2) Property of the corporation representing at least 75 percent of the adjusted basis for determining loss of all the property of the corporation must be deemed destroyed or seized under the provisions of section 127 (a) (1) or (2), relating to property actually destroyed or seized during military or naval operations or located in an enemy country or in an area under the control of such country. For the purposes of this provision:

(i) The adjusted basis for determining loss of all the property of the corporation is determined as of the date immediately preceding the first date on which any property of the corporation is deemed destroyed or seized under the provisions of section 127 (a) (1) (2), or (3), except that if such determination would produce a greater amount if made as of any later date falling within or before the taxable year in which the loss is sustained, it is made as of such later date on which it produces the greatest amount. If any property of the corporation which is at no time treated as destroyed or seized under section 127 (a) is 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, or obligations issued or guaranteed as to principal or interest by the United States, then the

adjusted basis of such property shall not be taken into account in determining the adjusted basis of all the property of the corporation.

(ii) The property of the corporation described in section 127 (a) (1) or (2) deemed to be destroyed or seized represents at least 75 percent of the amount determined under (i) above as the adjusted basis for determining loss of all the property of the corporation if the aggregate of the adjusted bases for determining loss of all such property described in section 127 (a) (1) or (2) (determined for each such property as of the date prescribed under (i), except that the date immediately preceding the date it is deemed destroyed or seized shall be used if the property was not held by the corporation on the date prescribed in (i) or was deemed destroyed or seized on or before such date) is not less than 75 percent of the amount so determined under (i). The property described in section 127 (a) (1) or (2) which is included in determining such 75 percent amount is property owned by the corporation, for the destruction or seizure of which it could claim a war loss under section 127 (a) (1) or (2). Property of the corporation deemed destroyed or seized under section 127 (a) (3) is not included in determining such 75 percent amount even though such property may be an interest in property described in section 127 (a) (1) or (2).

(3) The corporation must completely liquidate within one year after the last property of the corporation described in section 127 (a) (1) or (2) is deemed destroyed or seized under such section, except that if such year expires before April 21, 1943 (the last date falling within six months after the enactment of the Revenue Act of 1942), the liquidation may be completed on or before that date. The corporation has completely liquidated if it has distributed to its shareholders all the assets which it is able to distribute and all its rights to assets, such as assets treated as war losses under section 127 (a) (1) or (2), which it is not able to distribute. Dissolution of the corporation is not necessary if the distribution otherwise results in a complete liquidation. In some cases the corporation may not be able to comply with certain formalities required by the law applicable in the case of a liquidation. For example, a corporation chartered by a foreign government not at war with the United States may be required to hold its shareholders' meetings, at which any liquidation must be approved, in a city occupied by the forces of a country at war with such government and with the United States; due to the occupation of that city by the enemy country the shareholders' meeting, approving the liquidation, is held at some other place. In such cases, the validity of the liquidation will be determined on the basis of whether the corporation in good faith has complied as fully as possible with all provisions of law applicable to such liquidation. The liquidation will not be considered invalid because of the absence of any formalities incident to such liquidation with which the corporation was not able to comply, unless such liquidation is actually declared invalid by any appropriate authority. If a war loss upon any such liquidation has been allowed upon audit by the Commissioner, if the taxpayer attached a statement to the return in which such loss was claimed, as a part thereof, to the effect that he had determined to consider the liquidation valid for all purposes, including the treatment as a recovery by him for the purposes of section 127 (c) of any recovery with respect to the assets and rights to assets distributed to him, and if the taxpayer in such statement waived the benefits of any period of limitations which would prevent the adjustment of his tax liability on account of the invalidity of the liquidation at any time at which he should contend that the liquidation was invalid and the Commissioner should agree to permit him so to change his position, then (in the absence of such change of position with the permission of the Commissioner) the war loss will not be subsequently disallowed even though the liquidation may be declared invalid by some appropriate authority.

(b) *Determination of amount of war loss.* If the provisions of paragraph (a) of this section are met, the loss sustained by the taxpayer upon the liquidation described in such paragraph is considered a war loss to the extent it is attributable to the property of the corporation described in section 127 (a) (1) or (2) which is deemed destroyed or seized. The loss sustained by the taxpayer upon the liquidation of the corporation is attributable to property of the corporation described in section 127 (a) (1) or (2), which is deemed destroyed or seized, to the extent that such loss would be decreased (but not decreased below zero) if the corporation at the time of the liquidation owned additional assets, which it could distribute, having a fair market value equal to that of the property described in section 127 (a) (1) or (2), determined for each such property as of the date immediately preceding the date it is deemed destroyed or seized. The amount of the war loss sustained by the taxpayer is the amount of such decrease. For example, a taxpayer decribed in paragraph (a) of this section sustained a loss of $1,000 upon a liquidation described in such subsection. If the corporation owned additional distributable assets at the time of the liquidation having a fair market value equal to that of its property described in section 127 (a) (1) or (2) (determined as of the date immediately preceding the date such property is deemed destroyed or seized), it would have distributed $800 of such assets to the taxpayer, and his loss upon the liquidation would accordingly have been reduced by this amount. Therefore, $800 of the $1,000 loss sustained by the taxpayer is attributable to the property of the corporation described in section 127 (a) (1) or (2), and the taxpayer has a war loss of $800. The remaining $200 loss sustained on the liquidation has the same character it would have had if section 127 (e) had not applied to any portion of such loss.

If the taxpayer has more than one kind of stock or other interest in the corporation, the determination of the war loss by reference to the decrease in the loss on the liquidation must be made for each such interest, since to the extent the loss on any such interest would be reduced below zero (by the distribution of the assets equal in value to the property described in section 127 (a) (1) or (2)) no war loss is sustained by the taxpayer. For example, the taxpayer owns stock A and stock B in the corporation, and upon its liquidation he sustains a loss of $1,000 with respect to A and of $2,000 with respect to B, or $3,000 in all. Upon a distribution of assets equal in value to the property of the corporation described in section 127 (a) (1) or (2), the taxpayer would receive $1,800, reducing his loss on the liquidation by that amount. However, of this $1,800, $1,200 would be received with respect to the A stock, for which the loss on the liquidation was only $1,000. Therefore, only $1,000 of the amount received with respect to the A stock is a war loss. $600 would be received with respect to the B stock, and all of this amount is a war loss since it would not reduce the $2,000 loss on B below zero. Therefore, the war loss of the taxpayer on the liquidation is $1,600 ($1,000 plus $600) and not the $1,800 computed on the basis of the taxpayer's total interest in the corporation.

For the purposes of the preceding paragraphs of this paragraph, the loss sustained by the taxpayer upon the liquidation described in paragraph (a) of this section is determined under sections 111 and 115. Such loss is determined without regard to the provisions of section 112, relating to the nonrecognition of gains and losses upon certain exchanges, but such provisions apply to that part of the loss which is not treated as a war loss. In determining the loss of the taxpayer upon the liquidation, no value shall be ascribed to the possibility of a recovery of the property of the corporation described in section 127, deemed destroyed or seized, the rights to which are distributed to him, or of compensation (other than insurance or similar indemnity) on account of its destruction or seizure. Any recovery in the taxable year with respect to such rights is taken into account under section 127 (b) in determining the amount deductible on account of the war loss.

The war loss described in this section is deemed to result from the destruction or seizure of the taxpayer's interest in the corporation to which it is allocable. Therefore, this war loss, in the amount determined under section 127 (b) (see § 29.127 (b)-1), is deductible as an ordinary loss by casualty unless under section 117 (j), relating to losses on the involuntary conversion of certain property, it is treated as a loss on the sale or exchange of a capital asset. If part of the taxpayer's stock or other interests in the corporation is property described in section 117 (j), and part is not, then for the purposes of section 117 (j) the war loss must be allocated to the various interests in the corporation. The portion

of any interest in the corporation to which any part of the war loss is allocable is deemed destroyed or seized under section 127 (e), and the part of the war loss allocated to such interest is deemed to result from such destruction or seizure. The allocation of the war loss among the stock and other interests of the taxpayer in the corporation is made as follows:

The war loss is apportioned among the stock and other interests of the taxpayer in the corporation in the amounts by which the losses with respect to such interests, sustained upon the liquidation, would be decreased if the corporation had distributed, as described above for the determination of the amount of the war loss, assets equal in value to its property described in section 127 (a) (1) or (2). The war loss is allocable to that part of the stock or other interest of the taxpayer which is the same portion of such interest as the war loss apportioned to such interest is of the loss with respect to such interest sustained upon the liquidation.

For example, the taxpayer owns stock of class A and stock of class B in a corporation. Upon the liquidation described in paragraph (a) of this section it sustains a loss of $1,000 on the A stock and $2,000 on the B stock, a total loss of $3,000. If the corporation had distributed assets equal in value to its property described in section 127 (a) (1) or (2), the taxpayer would have received $1,400, $1,000 with respect to A and $400 with respect to B, reducing his loss on each by such amount. Therefore, of his $1,400 war loss, $1,000 is apportioned to A and $400 to B. The war loss is allocable to all of the A stock $\left(\frac{\$1{,}000 \text{ war loss}}{\$1{,}000 \text{ liquidation loss}} \text{ times A}\right)$, and the $1,000 war loss apportioned to the A stock is deemed to result from its destruction or seizure. Similarly, the war loss is allocable to 20 percent of the B stock $\left(\frac{\$400 \text{ war loss}}{\$2{,}000 \text{ liquidation loss}} \text{ times B}\right)$, and the $400 war loss apportioned to B is deemed to result from the destruction or seizure of a 20 percent interest in the B stock owned by the taxpayer.

[SEC. 127. WAR LOSSES—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.

§ 29.127 (f)-1 *Determination of tax benefits from allowable deductions.* 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 the taxpayer, or of any tax imposed in lieu of such taxes, 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 of the Internal Revenue Code. In determining that part of the aggregate of the deductions on account of war losses which, if disallowed, would not result in an increase in any such income tax of the taxpayer, there shall first be excluded for each taxable year affected the deductions and credits on account of the bad debt, tax, and delinquency amounts which under section 22 (b) (12) and the regulations thereunder are treated as not resulting in a tax benefit. 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.

Any deduction allowable for a taxable year on account of a war loss under section 127 which (a) 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 (b) 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 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.

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 of the Internal Revenue Code.

SEC. 128. RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES [as added by sec. 157 (a), Rev. Act 1942].

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.

§ 29.128-1 *Recovery of unconstitutional taxes*—(a) *In general.* Subject to to the limitations herein, a taxpayer who recovers unconstitutional Federal taxes, such as taxes imposed by the Agricultural Adjustment Act, 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.

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.

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.

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).

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.* The election provided for in paragraph (a)

of this section shall be made by the taxpayer filing with the Commissioner 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. Where the recovery antedates February 10, 1943 (the date of approval of Treasury Decision 5226), the statement of election must be filed within 90 days after such approval date. 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 (1) to the Commissioner'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 (2) 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 prior to the filing of such consent.

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.

CREDITS AGAINST TAX

SEC. 131. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES [as amended by sec. 216, Rev. Act 1939; secs. 158 (a) (d) (e) (f), 172 (d), Rev. Act 1942].

(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 or section 450, 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 United States.* In the case of a resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) *Alien resident of United States.* In the case of an alien resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) *Partnerships and estates.* In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

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.

(b) *Limit on credit.* The amount of the credit taken under this section shall be subject to each of the following limitations:

(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income, in the case of a taxpayer other than a corporation, or to the sum of the normal-tax net income and the amount of the credit for adjusted excess profits net income provided in section 26 (e), in the case of a corporation, for the same taxable year; and

(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources without the United States bears to his entire net income, in the case of a taxpayer other than a corporation, or to the sum of the normal-tax net income and the amount of the credit for adjusted excess profits net income provided in section 26 (e), in the case of a corporation, for the same taxable year.

(c) *Adjustments on payment of accrued taxes.* If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 322. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such sum as the Commissioner may require, conditioned upon the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(d) *Year in which credit taken.* The credits provided for in this section may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject, however, to the conditions prescribed in subsection (c) of this section. If the taxpayer elects to take such credits in the year in which the taxes of the foreign country or the possession of the United States accrued, the credits for all subsequent years shall be taken upon the same basis, and no portion of any such taxes shall be allowed as a deduction in the same or any succeeding year.

(e) *Proof of credits.* The credits provided in this section shall be allowed only if the taxpayer establishes to the satisfaction of the Commissioner (1) the total amount of income derived from sources without the United States, determined as provided in section 119, (2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this section, such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary, and (3) all other information necessary for the verification and computation of such credits.

(f) *Taxes of foreign subsidiary*—(1) *Foreign subsidiary of domestic corporation.* For the purposes of this section, a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid 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: *Provided,* That the amount of tax deemed to have been paid by such domestic corporation under this subsection shall in no case exceed the same proportion of the tax against which credit is taken which the amount of such dividends bears to the amount of the normal-tax net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subsection in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(2) *Foreign subsidiary of foreign corporation.* If such foreign corporation owns all the voting stock (except qualifying shares) 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.

(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.

(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 466 (e).

§ 29.131-1 *Analysis of credit for taxes.* 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.

In the case of an alien resident of the United States who chooses to claim a credit for such taxes 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.

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.

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 prior to 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 § 29.23 (c)-1.

For taxable years beginning before January 1, 1943, no credit for taxes shall be allowed against the tax imposed under section 102, relating to surtax on corporations improperly accumulating surplus, and for taxable years beginning after December 31, 1942, credit for taxes shall be allowed neither against the tax imposed under section 102, relating to surtax on corporations improperly accumulating surplus, nor against the victory tax imposed under section 450.

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.

§ 29.131-2 *Meaning of terms.* 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. For the purposes of section 131 and section 23 (c) (1) 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 1943 with respect to its tax liability to the X country for the year 1942. 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 1942. "Foreign country" means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income, war-profits, or excess-profits taxes. "Any possession of the United States" includes, among others, Puerto Rico, the Philippines, and the Virgin Islands. But see section 251. As to the meaning of "sources," see section 119. (See also section 3797.)

§ 29.131-3 *Conditions of allowance of credit.* 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 there called for and with the calculations of credits there indicated, and must be duly signed and sworn to or affirmed. 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.

Where it has been established to the satisfaction of the Commissioner that it is impossible (1) to furnish a receipt for such foreign tax payment or (2) the foreign tax return, or (3) direct evidence of the amount of tax withheld at the source, secondary evidence of the payment or accrual of the tax or of the withholding of the tax may, in his discretion, and under such rules as he may prescribe, be accepted by the Commissioner.

In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual and Form 1119 by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. (See also section 1126 of the Revenue Act of 1926, as amended.)

For credit where taxes are paid by a foreign corporation controlled by a domestic corporation, see § 29.131-7. A claim for credit in such a case is also to be made on Form 1118. See § 29.131-6 with reference to the option granted by section 131 (d).

The taxpayer may, with respect to a particular taxable year, claim the benefits of section 131 at any time prior to 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.

§ 29.131-4 *Redetermination of tax when credit proves incorrect.* In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such tax-

payer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of section 322.

§ 29.131-5 *Countries which do or do not satisfy the similar credit requirement.* A country satisfies the similar credit requirement of section 131 (a) (3), as to income tax paid to such country, either by allowing to citizens of the United States residing in such country a credit for the amount of income taxes paid to the United States, or, in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such country. A country does not satisfy the similar credit requirement of section 131 (a) (3) if it does not allow any credit to citizens of the United States residing in such country for the amount of income taxes paid to the United States, or if such country does not impose any income taxes. If the country of which a resident alien is a citizen or subject does not allow to a United States citizen residing in such country a credit for taxes paid by such citizen to another foreign country, no credit is allowed to such resident alien for taxes paid by him to such other foreign country.

§ 29.131-6 *When credit for taxes may be taken.* The credit for taxes provided by section 131 (a) may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed upon the accrual basis or upon the cash receipts and disbursements basis. Section 131 (d) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under 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.

If, however, under the provisions of § 29.43-1 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.

§ 29.131-7 *Taxes of subsidiary corporation*—(a) *Domestic corporation owning a majority of the stock of a foreign corporation.* In the case of a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes not only the income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States by such domestic corporation, but also income, war-profits, and excess-profits taxes deemed to have been paid determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued by such controlled foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. The amount of taxes deemed to have been paid is limited, however, to an amount which shall in no case exceed the same proportion of the tax against which the credit for foreign taxes is taken, which the amount of such dividends bears to the amount of the normal-tax net income of the domestic corporation in which such dividends are included. See, however, the limitations provided in section 131 (b) and § 29.131-8. If dividends are received from more than one controlled foreign corporation, the limitation is to be computed separately for the dividends received from each controlled foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to the taxes deemed to have been paid as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by a controlled foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

(b) *Foreign subsidiary of foreign subsidiary of a domestic parent corporation.* In the case of any foreign corporation coming within the scope of section 131 (f) (1) and paragraph (a) of this section in which such foreign corporation (hereinafter referred to as the foreign parent) owns all of the stock, except qualifying shares, of another foreign corporation (hereinafter referred to as the foreign subsidiary), the foreign parent, receiving a dividend from the foreign subsidiary, shall be deemed to have paid that proportion of the income, war-profits, and excess-profits taxes actually paid by the foreign subsidiary upon or with respect to the accumulated profits of such foreign subsidiary which the amount of such dividends bears to the amount of such accumulated profits. Such tax is then taken into consideration in the determination of the amount of income, war-profits, and excess-profits taxes paid or deemed to have been paid by the foreign parent upon or with respect to its own accumulated profits from which dividends were paid by such foreign parent to its domestic parent corporation.

The application of these principles in the determination of the amount of the foreign tax available as a basis for a credit to the domestic parent 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 1942 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

$$\frac{25,000}{150,000}\times \$45,000, \text{ or } \$7,500.$$

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

$$\frac{50,000}{200,000}\times (\$60,000 \text{ plus } \$7,500) \text{ equals } \$16,875.$$

§ 29.131-8 *Limitations on credit for foreign taxes.* The amount of the income and profits taxes paid or accrued (including the taxes which, in accordance with the provisions of section 131 (f), are deemed to have been paid) during the taxable year to each foreign country or possession of the United States, limited under section 131 (b) (1) so as not to exceed that proportion of the tax against which credit is taken which the taxpayer's net income from sources within such country or possession bears to (1) his entire net income, or (2) the sum of the normal-tax net income and the amount of the credit for adjusted excess profits net income provided in section 26 (e) in the case of a corporation, for the same taxable year, is the tentative credit in respect of the taxes paid or accrued to such country or possession. The sum of these tentative credits, limited under section 131 (b) (2) so as not to exceed the same proportion of the tax against which credit is taken which the taxpayer's net income from sources without the United States bears to (1) his entire net income, or (2) the normal-tax net income computed without the credit for adjusted excess profits net income provided in section 26 (e) in the case of a corporation, 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. In computing the tax against which the credit is taken there must, for taxable years beginning before January 1, 1943, be excluded the tax, if any, imposed by

section 102, and for taxable years beginning after December 31, 1942, there must be excluded both the tax imposed by section 102 and the tax imposed by section 450.

The operation of the limitations on the credit for foreign taxes paid by individuals may be illustrated by the following examples:

Example (1). In 1942, A, a citizen of the United States, had a net income for services rendered within the United States amounting to $50,000 and a net income from sources within Great Britain of $25,000. He is entitled to a personal exemption of $500. The credit for foreign taxes allowable to A in his return for the calendar year 1942 is $14,788.67, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	25,000.00
Total net income	75,000.00
United States income tax on $75,000	44,366.00
British income and profits taxes	15,200.00
Limitation on British income and profits taxes under section 131 (b) (1) and (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$44,366\right)$	14,788.67
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitations under section 131 (b) (1) and (2))	14,788.67

Example (2). If, in example (1), above, A had a net income from sources within Great Britain of $15,000 and a net income from sources within Canada of $10,000 and the income and profits taxes paid or accrued to Great Britain and Canada were $8,950 and $4,500, respectively, the credit for foreign taxes allowable to A would be $13,373.20, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	15,000.00
Income from sources within Canada	10,000.00
Total net income	75,000.00
United States income tax on $75,000	44,366.00
British income and profits taxes	8,950.00
Limitation on British income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{15,000}{75,000} \text{ of } \$44,366\right)$	8,873.20
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))	8,873.20
Canadian income and profits taxes	4,500.00
Limitation on Canadian income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{10,000}{75,000} \text{ of } \$44,366\right)$	5,915.47
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 ($8,873.20 plus $4,500)	$13,373.20
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$44,366\right)$	14,788.67
Total amount of credit allowable (sum of tentative credits, since such sum is within the limitation under section 131 (b) (2))	13,373.20

The operation of the limitations provided by section 131 (b) on the credit for foreign taxes paid by corporations may be illustrated by the following example:

Example. The net income for the calendar year 1942 and the income and profits taxes paid or accrued to foreign countries and possessions of the United States in the case of a domestic corporation were as follows:

Country	Net income	Less	Income and profits taxes (paid or accrued)
United States	$200,000		
Great Britain	30,000		$17,000
Canada	20,000		5,600
Brazil	40,000		5,800
Argentine Republic	60,000		None
Mexico		$100,000	None
Puerto Rico	10,000		2,250
France (dividend)	50,000		[1] 9,000
France (branch)	20,000		6,000

[1] Withheld.

Net income		$330,000.00
Less:		
85 percent on dividends received from domestic corporations ($50,000)	$42,500.00	
Interest on obligations of the United States	25,000.00	
		67,500.00
Normal tax net income (before the credit for adjusted excess profits net income)		262,500.00
Less:		
Adjusted excess profits net income		105,000.00
Normal tax net income (after credit for adjusted excess profits net income)		157,500.00
Surtax net income ($330,000 minus ($42,500 plus $105,000))		182,500.00
Total foreign net income		130,000.00
United States tax (not including tax imposed under section 102)—		
Normal tax	$37,800.00	
Surtax	29,200.00	
		67,000.00

The income and losses from all foreign countries and possessions of the United States, except the dividend from sources within France, were derived from branch operations. Dividends of $50,000 were received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation. The French corporation paid to France income and profits taxes on income earned by it and in addition a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source.

The computation of the credit is as follows:

Great Britain

Income and profits tax paid or accrued	$17,000.00
Limitation under section 131 (b) (1) $\left(\frac{30,000}{262,500} \text{ of } \$67,000\right)$	7,657.14
Tentative credit	7,657.14

Canada

Income and profits tax paid or accrued	$5,600.00
Limitation under section 131 (b) (1) $\left(\frac{20,000}{262,500} \text{ of } \$67,000\right)$	5,104.76
Tentative credit	5,104.76

Brazil

Income and profits tax paid or accrued	$5,800.00
Limitation under section 131 (b) (1) $\left(\frac{40,000}{262,500} \text{ of } \$67,000\right)$	10,209.52
Tentative credit	5,800.00

Argentine Republic

Tentative credit	None.

Mexico

Tentative credit	None.

Puerto Rico

Income and profits tax paid or accrued	$2,250.00
Limitation under section 131 (b) (1) $\left(\frac{10,000}{262,500} \text{ of } \$67,000\right)$	2,552.38
Tentative credit	2,250.00

France

Dividend tax paid at source		$9,000.00
Income and profits taxes paid or accrued on branch operations		6,000.00
Income and profits taxes deemed under section 131 (f) to have been paid, computed, as follows:		
Dividend received on December 31 of the taxable year	$50,000.00	
Income of French corporation earned during taxable year	200,000.00	
Income and profits taxes paid to France on $200,000	30,000.00	
Accumulated profits ($200,000 minus $30,000)	170,000.00	
French taxes applicable to accumulated profits distributed $\left(\frac{50,000}{170,000}\right)$ of $\left(\frac{170,000}{200,000} \text{ of } \$30,000\right)$	7,500.00	
Limitation under section 131 (f) $\left(\frac{50,000}{262,500} \text{ of } \$67,000\right)$	12,761.90	
Income and profits taxes deemed to have been paid (French taxes applicable to accumulated profits distributed to domestic corporation, within the limitation of section 131 (f))		7,500.00
Total income and profits taxes paid or accrued and deemed to have been paid to France		22,500.00

Limitation under section 131 (b)

(1) $\left(\frac{70,000}{262,500}\text{ of } \$67,000\right)$	$17,866.66
Tentative credit	17,866.66

Sum of tentative credits

Great Britain	$7,657.14
Canada	5,104.76
Brazil	5,800.00
Puerto Rico	2,250.00
France	17,866.66
	38,678.56
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{130,000}{262,500}\text{ of } \$67,000\right)$	33,180.94
Total amount of credit allowable (sum of tentative credits or the limitation under section 131 (b) (2), whichever is the lesser)	33,180.94

The deduction of excess profits tax imposed by subchapter E of chapter 2 is not allowed in the computation of net income for the purposes of chapter 1. However, in the determination of normal-tax net income, there is allowed as a credit against the adjusted net income the amount of income subject to the tax imposed by subchapter E of chapter 2 (see section 13 (a) (2). It is, therefore, provided in section 131 (b) that in the case of a domestic corporation the amount of the credit with respect to the tax paid or accrued to any country shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's net income from sources within such country bears to the entire normal-tax net income of such corporation computed without the allowance of the credit for adjusted excess profits net income. Hence, the total amount of the credit shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's net income from sources without the United States bears to the entire normal-tax net income computed without the allowance of the credit for adjusted excess profits net income. These principles may be illustrated by the following example:

Example. The following facts exist for the calendar year 1942 with respect to the A Corporation which makes its income tax returns on the calendar year basis:

Normal-tax net income (computed without the credit for adjusted excess profits net income)	$250,000
Less: Adjusted excess profits net income	75,000
Normal-tax net income (after credit for adjusted excess profits net income)	175,000
Net income from country A	100,000
Foreign tax paid on country A income	35,000
Total normal tax and surtax	70,000

Computation of foreign tax credit for purposes of normal tax and surtax

$$\frac{100{,}000 \text{ (net income from A country)}}{250{,}000 \text{ (normal-tax net income before deducting adjusted excess profits net income)}} \times \$70{,}000 = 28{,}000$$

Amount allowable as a credit	28,000

In the event that 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 net income from sources without the United States and the entire normal-tax net income of the corporation computed without the credit for adjusted excess profits net income.

§ 29.131-9 *Joint return by husband and wife.* In case of a husband and wife making a joint return, the 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, and the limitations prescribed by section 131 (b) upon such credit 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.

RETURNS AND PAYMENT OF TAX

SEC. 141. CONSOLIDATED RETURNS [as amended by sec. 210 (b), Rev. Act 1939, repealing subsection (j); sec. 159 (a), Rev. Act 1942].

(a) *Privilege to file consolidated income and excess-profits-tax returns.* An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax 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 returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such corporation shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation shall relate only to the consolidated excess-profits-tax regulations.

(b) *Regulations.* The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns 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. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

(c) *Computation and payment of tax.* In any case in which consolidated income-tax and excess-profits-tax returns are made or are required to be made, the taxes 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 returns; 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. Only one specific exemption of $5,000 provided in section 710 (b) (1) shall be allowed for the entire affiliated group of corporations for the purposes of the tax imposed by Subchapter E of Chapter 2.

(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 under section 101 from the tax imposed by this chapter.

(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.

(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 and of Subchapter E of Chapter 2 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.

§ 29.141-1 *Consolidated income and excess profits tax returns of affiliated corporations*—(a) *In general.* Section 141 prescribes rules for the making of both consolidated income and excess profits tax returns by an affiliated group of corporations. Regulations promulgated as Parts 23 and 30 of this chapter are applicable, respectively, to the making of consolidated income and excess profits tax returns, and to 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.

(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.* The privilege of filing consolidated income and excess profits tax 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 returns shall include the income of such corporation for the part of the year during which it is a member of the group. However, a corporation which is not a member of such group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, shall not be considered a member of such group for consolidated income tax return purposes for such year, but shall be considered a member of such group for consolidated excess profits tax return purposes for such year. An "includible corporation" is defined by section 141 (e) to mean any corporation except:

(1) A corporation exempt under section 101 from the tax imposed by chapter 1;

(2) An insurance company subject to taxation under section 201 or 207 (except as provided in section 141 (f));

(3) A foreign corporation (except as provided in section 141 (g));

(4) 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;

(5) A corporation organized under the China Trade Act, 1922; and

(6) A regulated investment company subject to tax under Supplement Q (sections 361 and 362).

The consolidated income tax return and the consolidated 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.

Every corporation which is a member of an affiliated group making consolidated returns under section 141 is a member of such group both for consolidated income tax and consolidated excess profits tax return purposes, regardless of any exemption to which it might have been entitled if separate returns had been made. See sections 725 (b) and 727.

(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 corporations. 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 first consolidated income and excess profits tax returns for any taxable year beginning after December 31, 1941, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation, it must be included in both the consolidated income and excess profits tax returns of the affiliated group of which it is a member for each year for which such group makes or is required to make a consolidated return.

(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. In case the consolidated corporation surtax net income exceeds $25,000, but not $50,000, the surtax on the first $25,000 is $3,030 instead of $2,500 as provided in section 15 (b) (2) in the case of corporations not making a consolidated return.

SEC. 142. FIDUCIARY RETURNS [as amended by sec. 7 (b), Rev. Act 1940; sec. 112 (b), Rev. Act. 1941; sec. 131 (c), Rev. Act 1942].

(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 $500 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a gross income for the taxable year of $1,200 or over, if married and living with husband or wife;

(3) Every estate the gross income of which for the taxable year is $500 or over;

(4) 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 $500 or over, regardless of the amount of the net income; and

(5) 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 require-

ment. 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.

§ 29.142-1 *Fiduciary returns.* Every fiduciary, or at least one of joint fiduciaries, must make a return of income:

(a) *Returns for individuals.* For the individual whose income is in his charge, if the gross income of such individual is $500 or over, if single, or if married and not living with husband or wife for any part of the taxable year; or if such individual is married and was living with husband or wife for any part of the taxable year but not at the close of the taxable year and his gross income for the taxable year is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family); or if such individual is married and was living with husband or wife for the entire taxable year and the aggregate gross income of both husband and wife is $1,200 or over; or if such individual is married and was living with husband or wife at the close of the taxable year but not during the entire taxable year and the aggregate gross income of both husband and wife is $1,200 or over, or the aggregate gross income of both husband and wife is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to the status of either of them as head of a family), or

(b) *Returns for estates and trusts.* For the estate for which he acts if the gross income of such estate is $500 or over, and for the trust for which he acts if the gross income of such trust is $500 or over, or if any beneficiary of such as computed under section 162, is $100 or over, or if any beneficiary, of such estate or trust is a nonresident alien. A return shall be filed for the taxable year of an estate which is a period of less than 12 months if the gross income of the estate for such taxable year is greater than the personal exemption allowable to a single person having a similar taxable year. See §§ 29.25-7 and 29.47-1. The requirements as to the filing of a return for a trust remain the same regardless of whether the taxable year of the trust is a period of less than 12 months.

The return in case (a) shall be on Form 1040 or 1040A. In case (b) a return is required on Form 1041. A copy of the will or trust instrument sworn to by the fiduciary as a true and complete copy in cases in which the gross income of the estate or trust is $5,000 or over, must be filed with the fiduciary return of the estate or trust, together with a statement by the fiduciary indicating the provisions of the will or trust instrument which, in his opinion, determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively. If, however, a copy of the will or trust instrument, or statement relating to the provisions of the will or trust instrument, has once been filed, it need not again be filed if the fiduciary return contains a statement showing when and where it was filed. If the trust instrument is amended in any way after such copy has been filed, a copy of the amendment, together with a statement by the fiduciary, indicating the effect, if any, in his opinion, of such amendment on the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively, must be filed with the return for the taxable year in which the amendment was made. See § 29.142-5 for returns in cases where any beneficiary is a nonresident alien. If the gross income of a decedent from the begining of the taxable year to the date of his death was equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family), the executor or administrator shall make a return for such decedent. (See § 29.25-7.)

For information returns required to be made by fiduciaries under section 147, see § 29.147-1.

As to further duties and liabilities of fiduciaries, see section 312.

§ 29.142-2 *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 equal to, or in excess of, the credit allowed such person by section 25 (b) (1) and (3) (computed without regard to the status of the minor or insane person as head of a family) must make a return for such person on Form 1040 or 1040A and pay the tax, unless in the case of a minor the minor himself makes a return or causes it to be made. (See § 29.25-3.)

For the purpose of determining the liability of a fiduciary to render a return under the provisions of the preceding paragraph in cases where the minor or the incompetent is married and was living with husband or wife at the close of the taxable year, it is the aggregate gross income or the aggregate net income of both husband and wife which is controlling. (See § 29.51-1.)

§ 29.142-3 *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.

§ 29.142-4 *Return by receiver.* A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on Form 1040 or 1040A. When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. (See section 52.) A receiver in charge of the business of a partnership shall render a return on Form 1065. A receiver of the rents and profits appointed to hold and operate a mortgaged parcel of real estate, but not in control of all the property or business of the mortgagor, and a receiver in partition proceedings, are not required to render returns of income. In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. (See also sections 147 and 148 (a).)

§ 29.142-5 *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 § 29.217-1.)

(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.

§ 29.142-6 *Time for filing return upon death, or termination of trust.* 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 §§ 29.47-1 and 29.142-1 for the last taxable year of a decedent, the executor or administrator of the decedent shall file such return at the time prescribed in § 29.53-1. If a return for the last taxable year of an estate or trust is required to be filed under the provisions of § 29.142-1, such return shall be filed at the time prescribed in § 29.53-1, 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).

The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. Consequently the only return required to be filed by the ancillary representative is on Form 1041, which shall be filed with the collector for his district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary. If the ancillary representative for the estate of a nonresident alien is a citizen or resident of the United States, and the domiciliary representative is a nonresident alien, such ancillary representative is required to render the return otherwise required of the domiciliary representative.

SEC. 143. WITHHOLDING OF TAX AT SOURCE [as amended by secs. 5 (a), 202, Rev. Act 1940, secs. 107 (a) (b), 109 (a), Rev. Act 1941; secs. 108, 160 (a), Rev. Act 1942].

(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. [NOTE: For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 103 (a) (c), Rev. Act 1942, set forth below. See also sec. 160 (a), Rev. Act 1942, set forth below.]

(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 credits provided in section 25 (b); nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under section 215.

(3) *Income of obligor and obligee.* The obligor shall not be allowed a deduction for the payment of the tax imposed by this 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, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (but only to the extent that any of the above items constitutes gross income from sources within the United States), or 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 provided for in subsection (a) of this section and except as otherwise provided in regulations prescribed by the Commissioner under section 215) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 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. [NOTE: For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 103 (a) (c), Rev. Act 1942, set forth below. See also sec. 160 (a), Rev. Act 1942, set forth below.]

(c) *Return and payment.* Every person required to deduct and withhold any tax under this section shall make return thereof on or before March 15 of each year and shall on or before June 15, in lieu of the time prescribed in section 56, pay the tax to the official of the United States Government authorized to receive it. Every such person is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this section.

(d) *Income of recipient.* Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) *Tax paid by recipient.* If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

(f) *Refunds and credits.* Where there has been an overpayment of tax under this section any refund or credit made under the provisions of section 322 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.

(g) *Cross reference.* For definition of "withholding agent", see section 3797 (a) (16).

SEC. 103. WITHHOLDING OF TAX AT SOURCE. (Revenue Act of 1942, Title I.)

(a) Sections 143 (a) and (b) * * * are amended by striking out "27½ per centum"

wherever occurring therein and inserting in lieu thereof "30 per centum".

* * * * *

(c) Subsection (a) shall apply only with respect to the period beginning with the tenth day after the date of the enactment of this Act.

SEC. 109. TREATY OBLIGATIONS. (Revenue Act of 1942, Title I.)

No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.

SEC. 160. ALIENS AND FOREIGN CORPORATIONS TREATED AS NONRESIDENTS. (Revenue Act of 1942, Title I.)

(a) (1) Section 143 (a) (1) (relating to withholding of tax on interest from tax-free covenant bonds) is amended by striking out "and not having any office or place of business therein" wherever occurring therein.

(2) Section 143 (b) (relating to withholding of the tax at the source on nonresident aliens) is amended by striking out "and not having any office or place of business therein", by striking out "and not having an office or place of business therein", and by striking out "or has an office or place of business therein."

* * * * *

(4) The amendments made by this subsection shall apply only with respect to the period beginning with the tenth day after the date of the enactment of this Act.

* * * * *

§ 29.143-1 *Withholding tax at source*—(a) *Withholding in general.* Withholding of a tax of 30 percent (27½ percent prior to October 31, 1942) 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, with respect to amounts paid prior to October 31, 1942, was engaged in trade or business or had an office or place of business therein) or to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States (or, with respect to amounts paid prior to October 31, 1942, not engaged in trade or business and not having any office or place of business therein), (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934 (but see paragraph (b) of this section), (3) dividends paid by a foreign corporation unless (i) such corporation is engaged in trade or business within the United States (or, with respect to amounts paid prior to October 31, 1942, was engaged in trade or business or had an office or place of business therein), and (ii) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States, as determined under the provisions of section 119, (4) dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China, and (5) except that such rate of 30 percent (27½ percent prior to October 31, 1942) 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 percent, as may be provided by treaty with such country. Under the regulations prescribed pursuant to the tax convention and protocol between the United States and Canada, signed March 4, 1942, effective generally January 1, 1941, the rate of tax to be withheld at the source has been reduced to 15 percent in the case of residents of Canada. Similarly, in accord with Article VII of the tax convention and protocol between the United States and Sweden, effective January 1, 1940, the rate of withholding shall, for a period of at least two years beginning with such date, be 10 percent with respect to dividends paid to residents of Sweden. Withholding is required in the case of interest paid on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. (See §§ 29.22 (b) (4)-4 and 29.22 (b) (4)-6, relating to the taxation of such interest, and § 29.143-4, relating to ownership certificates.)

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.

The tax must be withheld at the source from the gross amount of any distribution made by a corporation, other than a nontaxable distribution payable in stock or stock rights or a distribution in partial or complete liquidation, without regard to any claim that all or a portion of such distribution is not taxable. Appropriate adjustments, if any, will be made upon the filing of claims for refund.

The tax need not be withheld on accrued interest paid in connection with the sale of bonds between interest dates.

A tax of 30 percent (27½ percent prior to October 31, 1942) must be withheld from interest on bonds or securities not containing a tax-free covenant, or containing a tax-free covenant and issued on or after January 1, 1934, if the owner is unknown to the withholding agent, except where such interest represents income from sources without the United States.

For withholding in the case of income paid to nonresident foreign corporations, see § 29.144-1.

Resident or domestic fiduciaries are required to deduct the income tax at the source from all fixed or determinable annual or periodical gains, profits, and income of nonresident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Bond interest, dividends, or other fixed or determinable annual or periodical income paid to a nonresident alien fiduciary is subject to withholding even though the beneficiaries of the estate or trust are citizens or residents of the United States.

The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of section 166 or 167 is subject to withholding even though the beneficiaries of such trust are citizens or residents of the United States, and regardless of whether the beneficiaries are exempt from income tax.

A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act in its behalf under the withholding provisions of the Internal Revenue Code, is required to file notice of such appointment with the Commissioner of Internal Revenue, Withholding Returns Section, Washington, D. C., giving the name and address of the agent.

If, in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, or corporation, must deduct and withhold such taxes as would be required to be withheld by the assignor had not such sale or transfer been made.

For determining income from sources within the United States, see section 119.

As to who are nonresident alien individuals, see §§ 29.211-2 and 29.3797-8. For classification of foreign corporations, see §§ 29.231-2 and 29.3797-8. As to what partnerships are deemed to be nonresident partnerships, see § 29.3797-8.

For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see §§ 29.143-3 and 29.262-4.

(b) *Tax-free covenant bonds issued before January 1, 1934.* The withholding provisions of section 143 (a) (1) are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 143 (a) (1) bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, are issued when delivered. If a broker or other person acts as selling agent of the obligor the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

In order that the date of issue of bonds, mortgages, or deeds of trust, or other similar obligations of corporations containing a tax-free covenant may be readily determined by the owner, for the purpose of perparing the ownership certificates required under §§ 29.143-1 to 29.143-9, inclusive, the "issuing" or debtor corporation shall indicate, by an appropriate notation, the date of issue or use the phrase, "Issued on or after January 1, 1934," on each such obligation or in a statement accompanying the delivery of such obligation.

In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued

on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 143 (a) but falls within the class of interest described in section 143 (b).

In the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary, or a partnership, whether resident or nonresident, withholding of a tax of 2 percent is required, except that if the liability assumed by the obligor in connection with such a covenant does not exceed 2 percent of the interest, withholding is required at the rate of 30 percent (27½ percent prior to October 31, 1942) in the case of a nonresident alien, or a nonresident partnership composed in whole or in part of nonresident alien individuals, or if the owner is unknown to the withholding agent. The rates of withholding applicable to the interest on bonds or other obligations of a corporation containing a tax-free covenant, and issued before January 1, 1934, are applicable to interest on such obligations issued by a domestic corporation or a resident foreign corporation. However, withholding is not required in the case of interest payments on such bonds or obligations if such interest is not to be treated as income from sources within the United States under section 119 (a) (1) (B) and the payments are made to a nonresident alien or a partnership composed wholly of nonresident aliens. A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent upon the interest on its tax-free covenant bonds issued before January 1, 1934, paid to an individual or fiduciary who is a citizen or resident of the United States, or to a partnership any member of which is a citizen or resident, or to an unknown owner.

For withholding in the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to nonresident foreign corporations, see § 29.144-1.

Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified prior to January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued prior to January 1, 1934, are subject to the provisions of section 143 (a), provided appropriate authority existed for the modification of the trust deeds in this manner. The authority must have been contained in the original trust deeds or actually secured from the bondholders.

In the case of corporate bonds or other obligations containing a tax-free covenant, issued before January 1, 1934, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax may nevertheless be claimed by the bondholder as a credit against the total amount of income tax due in accordance with section 143 (d). The tax withheld at the source upon tax-free covenant bond interest included in the income of an estate or trust and taxable to the beneficiaries thereof (including the grantor of a trust subject to section 166 or 167) is allowable, pro rata, as a credit against (1) the tax required to be withheld by the fiduciary from the income of nonresident alien beneficiaries and (2) 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.

§ 29.143-2 *Fixed or determinable annual or periodical income.* 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.

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 periodical income. Such items as taxes, interest on mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

§ 29.143-3 *Exemption from withholding.* Withholding from interest on bonds or other obligations of corporations issued prior to January 1, 1934, containing a tax-free covenant shall not be required in the case of a citizen or resident if he files with the withholding agent when presenting interest coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating that his net income does not exceed his personal exemption and credit for dependents and (in the case of taxable years beginning after December 31, 1942) that his victory tax net income does not exceed the specific exemption of $624. 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, Withholding Returns Section, Washington, D. C., with a letter of transmittal.

The income of domestic corporations and of resident foreign corporations is free from withholding.

No withholding from dividends paid by a corporation organized under the China Trade Act, 1922, is required unless the dividends are treated as income from sources within the United States under section 119 and are distributed to:

(a) A nonresident alien other than a resident of China at the time of such distribution;

(b) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in China); or

(c) A nonresident foreign corporation (other than a corporation resident in China).

The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals, shall not be subject to deduction and withholding of income tax at the source, provided he is a resident of Canada or Mexico.

Payments made by the United States or other public or private agencies or employers to nonresident aliens brought into the United States for the purpose of the production and harvesting of agricultural commodities pursuant to Public Law 45 (78th Congress), approved April 29, 1943, shall not be subject to deduction and witholding of income tax at the source (see section 5 (b) of such Public Law 45).

The following items of fixed or determinable annual or periodical income from sources within the United States received by a citizen of France residing in France, or a corporation organized under the laws of France, are not subject to the withholding provisions of the Internal Revenue Code, since such income is exempt from Federal income tax under the provisions of the tax convention between the United States and France, signed April 27, 1932, and effective January 1, 1936:

(1) Amounts paid as consideration for the right to use patents, secret processes and formulas, trade-marks, and other analogous rights;

(2) Income received as copyright royalties; and

(3) Private pensions and life annuities.

The person paying such income should be notified by letter from the French citizen or corporation, as the case may be, that the income is exempt from taxation under the provisions of the convention and protocol referred to above. Such letter from a citizen of France shall contain his address and a statement that he is a citizen of France residing in France. The letter from such corporation shall contain the address of its office or place of business and a statement that it is a corporation organized under the laws of the Republic of France, and shall be signed by an officer of the corporation giving his official title. The letter of notification or a copy thereof should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Withholding Returns Section, Washington, D. C.

As to items of income received on or after January 1, 1940, by individual residents of Sweden or by Swedish corporations or other Swedish entities and not subject to the withholding provisions of the Internal Revenue Code, see the tax convention between the United States and Sweden, effective January 1, 1940, and the regulations thereunder.

As to items received on or after January 1, 1941, by individual residents of Canada and not subject to the withholding provisions of the Internal Revenue Code, see the tax convention and protocol between the United States and Canada, effective January 1, 1941, and the regulations thereunder.

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 any personal exemption or credit for dependents. Although a nonresident alien individual who is engaged in trade or business within the United States is entitled to the personal exemption of $500 (and a credit for dependents if he is a resident of Canada or Mexico), he is subject to the normal tax and the surtax imposed by sections 11 and 12 by reason of the provisions of section 211 (b) and to the victory tax imposed by section 450; and, in the case of such an individual, the benefit of the personal exemption and credit for dependents may not be received by filing a claim therefor with the witholding agent. However, in the determination of the tax to be withheld at the source under section 143 (b) with respect to remuneration paid on or after July 1, 1943, for labor or personal services performed within the United States by a nonresident alien, the benefit of the personal exemption of $500 shall be allowed, prorated upon the basis of $1.40 per day for the period of employment during any portion of which labor or personal services are performed within the United States by such alien. Thus if A, a nonresident alien seaman employed by the X Shipping Corporation, is paid upon the termination of the voyage and such voyage covers 100 days, and A performed personal services within the United States during, or incident to, such voyage, the amount of $140 will be allocated as the portion of the personal 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 sum of $120 is allocable to sources within the United States, there is no withholding. As to what constitutes remuneration for labor or personal services rendered within the United States, see section 119 (a) (3) and § 29.119-4. The amount of the compensation allocable to labor or personal services performed within the United States together with the amount of the personal exemption, prorated as set forth in this paragraph, shall be shown on the annual withholding return, Form 1042.

Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942), annuities and pensions received by individual residents of Canada are exempt from tax and are exempt from withholding with respect to payments of such items made on or after June 27, 1942.

§ 29.143-4 *Ownership certificates for bond interest.* In accordance with the provisions of section 147 (b), citizens and resident individuals and fiduciaries, resident partnerships and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates for each issue of such obligations regardless of the amount of the coupons. *However, in the case of interest coupons presented on or after January 1, 1943, such ownership certificates are required to be filed by such citizens, residents, fiduciaries, and partnerships only with respect to interest coupons on bonds, mortgages, or deeds of trust, or other similar obligations issued prior to January 1, 1934, and containing a tax-free covenant. In the case of interest on obligations of the United States or any agency or instrumentality thereof, regardless of the date of issuance thereof,* ownership certificates shall be filed by such citizens, residents, fiduciaries, and partnerships only in the case of interest *paid prior to January 1, 1943.*

In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

In all cases where the owner of bonds, mortgages, or deeds of trust, or other similar obligations of a corporation is a nonresident alien, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or where the owner is unknown, an ownership certificate for each issue of such obligations shall be filed when interest coupons for any amount are presented for payment. The ownership certificate is required 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 or after January 1, 1942, 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.

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.

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.

When interest coupons detached from corporate bonds, or (as to coupons presented on or after January 1, 1942) 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 monthly (quarterly, for the calendar year 1943 and subsequent calendar years) return on Form 1012. The bank shall also require the payee to prepare a certificate on Form 1001, crossing out "owner" and inserting "payee" and entering the amount of the

interest, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank.

Ownership certificates are required in connection with interest payments on registered bonds as in the case of coupon bonds, except that if ownership certificates are not furnished by the owner of such bonds, ownership certificates must be prepared by the withholding agent.

§ 29.143-5 *Form of certificate for citizens or residents.* For the purpose of § 29.143-4, 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 citizen 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.

§ 29.143-6 *Form of certificate for nonresident aliens, nonresident foreign corporations, and unknown owners.* For the purpose of § 29.143-4, 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.

§ 29.143-7 *Return and payment of tax withheld.* Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld from interest on bonds or other obligations of corporations 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 collector for the district in which the withholding agent is located. The withholding agent shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the monthly return. Such of the forms as report interest from which the tax is to be withheld should be listed on the monthly return. While the forms reporting interest from which no tax is to be withheld need not be listed on the return, the number of such forms submitted should be entered in the space provided. However, for the calendar year 1943 and subsequent calendar years the withholding agent 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. 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 § 29.143-5), 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.

Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 15 on Form 1042, showing the amount of tax required to be withheld from each nonresident alien, nonresident partnership composed in whole or in part of nonresident aliens, or nonresident foreign corporation to which income other than bond interest was paid during the previous taxable year. Form 1042 should be filed with the collector for the district in which the withholding agent is located. Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, in addition to the withholding return on Form 1042, with respect to the items of income from which a tax of only 15 percent was withheld from persons whose addresses are in Canada (5 percent in the case of dividends falling within the scope of paragraph 2 of Article XI of the convention). There shall be reported on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns (quarterly, for the calendar year 1943 and subsequent calendar years) on Form 1012, including items of interest where the liability for withholding is only 2 percent.

In every case the tax withheld must be paid to the collector on or before June 15 of the following year. For penalties and additions to the tax attaching upon failure to make such returns or such payments, see sections 145 and 291.

If a debtor corporation has designated a person to act for it as withholding agent, and such person has not withheld any tax from the income nor received any funds from the debtor corporation to pay the tax which the debtor corporation assumed in connection with its tax-free covenant bonds, such person cannot be held liable for the tax assumed by the debtor corporation merely by reason of such person's appointment as withholding agent. If a duly authorized withholding agent has become insolvent or for any other reason fails to make payment to the collector of internal revenue of money deposited with it by the debtor corporation to pay taxes, or money withheld from bondholders, the debtor corporation is not discharged of its liability under section 143 (a) (1), since the withholding agent is merely the agent of the debtor corporation.

In any case where income is payable in any medium other than money, the withholding agent shall not release the property so received until it has been placed in funds sufficient to enable it to pay over in money the tax required to be withheld with respect to such income.

§ 29.143-8 *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.

§ 29.143-9 *Return of income from which tax was withheld.* The entire amount of the income from which the tax was withheld shall be included in gross income in the return required to be made by the recipient of the income without deduction for such payment of the tax but any tax so withheld shall be credited against the total income tax as computed in the taxpayer's return. (See, however, § 29.142-5.) If the tax is paid by the recipient of the income or by the withholding agent it shall not be recollected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

Tax withheld at the source upon fixed or determinable annual or periodical income paid to nonresident alien fiduciaries is deemed to have been paid by the persons ultimately liable for the tax upon such income. Accordingly, if a person is subject to the taxes imposed by section 11, 12, 13, 14, or 15 (and, for a taxable year beginning after December 31, 1942, the victory tax imposed by section 450), upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to the income so taxed to such person shall be credited against the amount of the income tax computed upon his return, and any excess shall be credited against any income, war-profits, or excess-profits tax, or installment thereof, then due from such person, and any balance shall be refunded.

SEC. 144. PAYMENT OF CORPORATION INCOME TAX AT SOURCE [as amended by sec. 5 (b), Rev. Act 1940; secs. 107 (a), 103 (a), Rev. Act 1941; secs. 103 (a), 160 (a), Rev. Act 1942].

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 sec-

tion 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. [NOTE: For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 108 (a) (c), Rev. Act 1942, set forth below. See also sec. 160 (a), Rev. Act 1942, set forth below.]

SEC. 108. WITHHOLDING OF TAX AT SOURCE. (Revenue Act of 1942, Title I.)

(a) Sections * * * and 144 are amended by striking out "27½ per centum" wherever occurring therein and inserting in lieu thereof "30 per centum".

* * * * *

(c) Subsection (a) shall apply only with respect to the period beginning with the tenth day after the date of the enactment of this Act.

SEC. 109. TREATY OBLIGATIONS. (Revenue Act of 1942, Title I.)

No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.

SEC. 160. ALIENS AND FOREIGN CORPORATIONS TREATED AS NONRESIDENTS. (Revenue Act of 1942, Title I.)

(a) * * *

(3) Section 144 (relating to payment of corporation income tax at source) is amended by striking out "and not having any office or place of business therein".

(4) The amendments made by this subsection shall apply only with respect to the period beginning with the tenth day after the date of the enactment of this Act.

* * * * *

§ 29.144-1 *Withholding in the case of nonresident foreign corporations.* A tax of 30 percent (27½ percent prior to October 31, 1942) is required to be withheld in the case of fixed or determinable annual or periodical income paid to a nonresident foreign corporation except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to such corporation, 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. However, in accord with Article VII of the tax convention and protocol between the United States and Sweden, effective January 1, 1940, the rate of withholding shall, for a period of at least two years beginning with such date, be 10 percent with respect to dividends paid to a corporation or other entity created or organized under the laws of Sweden. Under the regulations prescribed pursuant to the tax convention and protocol between the United States and Canada, signed March 4, 1942, and effective generally January 1, 1941, the tax to be withheld at the source has been reduced to 15 percent in the case of corporations organized under the laws of Canada.

Withholding is required in the case of interest paid on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. (See §§ 29.22 (b) (4)-4 and 29.22 (b) (4)-6, relating to the taxation of such interest, and § 29.143-4, relating to ownership certificates.)

Withholding of a tax at the rate of 2 percent is required in the case of interest paid to a nonresident foreign corporation, upon bonds or other obligations of a corporation issued prior to January 1, 1934, and containing a tax-free covenant, if the liability assumed by the obligor exceeds 2 percent of the interest and the interest is treated as income from sources within the United States.

A tax of 30 percent (27½ percent prior to October 31, 1942) is required to be withheld from dividends (other than dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China) from sources within the United States paid to a nonresident foreign corporation, except that such rate of 30 percent (27½ percent prior to October 31, 1942) shall be reduced, 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, to such rate (not less than 5 percent) as may be provided by treaty with such country. Under the regulations prescribed pursuant to the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) the rate of tax to be withheld at the source has been reduced to 15 percent effective June 27, 1942, in the case of nonresident corporations organized under the laws of Canada. Dividends paid to such corporations and conforming to the provisions of paragraph 2 of Article XI of such convention are after such effective date subject to withholding at the reduced rate of 5 percent. See §§ 7.10 to 7.17, inclusive, of this chapter,[1] approved June 27, 1942. Dividends paid by a foreign corporation are not, however, subject to withholding unless such corporation is engaged in trade or business within the United States (or, in the case of dividends paid before October 31, 1942, if such corporation was engaged in trade or business within the United States or had an office or place of business therein) and more than 85 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 119. (See also section 143.)

For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see §§ 29.143-3 and 29.262-4.

[1] 7 F.R. 4825.

Under the provisions of section 143 (b), as amended by section 108 of the Revenue Act of 1942, 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.

§ 29.144-2 *Aids to withholding agents in determining liability for withholding of tax.* Since no withholding of tax on bond interest, dividends, or other income is required in the case of a resident foreign corporation (see § 29.143-3), 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, Withholding Returns Section, Washington, D. C. The same procedure should be followed in the case of resident partnerships, composed in whole or in part of nonresident aliens, not subject to the withholding provisions of the Code except in the case of interest on tax-free covenant bonds. The letter should be signed by a member of the firm.

When a payor corporation, or any other person (including a nominee), having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of 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.

The following tables of withholding rates under the Internal Revenue Code, as modified by tax conventions between the United States and other countries, have been prepared for the purpose of making a summary of such rates readily available to withholding agents:

I. FOR THE PERIOD PRIOR TO OCTOBER 31, 1942

Classes of taxpayers	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes over 2 percent of the tax	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes not over 2 percent of the tax	Corporate bond interest: Without tax-free covenant or issued on or after Jan. 1, 1934, with tax-free covenant	Salary or other compensation for personal services	Other fixed or determinable annual or periodical income, including dividends, from sources within the United States
	Percent	Percent	Percent	Percent	Percent
1. Citizen or resident individual, fiduciary, or partnership	2	2			
2. Nonresident, individual, fiduciary, or partnership	2	27½	27½	[1] 27½	[2] 27½
3. Domestic corporation or resident foreign corporation					
4. Nonresident foreign corporation	2	27½	27½	27½	[2, 3] 27½
5. Individual, fiduciary, or partnership, resident of of Canada; and corporation organized under laws of Canada	2	15	15	15	[4] 15
6. Unknown owner	2	27½	27½		

[1] Salary or compensation for personal services rendered in the United States is not subject to withholding in the case of nonresident aliens, residents of Canada or Mexico, who enter and leave the United States at frequent intervals.
[2] In the case of a resident of Sweden or a corporation or other entity organized under the laws of Sweden the rate with respect to dividends is 10 percent for at least two years beginning January 1, 1940 (see part 25 of this chapter).
[3] Interest on any noncorporate security the owner of which is unknown to the withholding agent is subject to withholding at the rate of 27½ percent.
[4] Subject to the provisions of Article XI(2) of the tax convention and protocol between the United States and Canada (see §§ 7.10 to 7.17, inclusive, of this chapter.)

II. FOR THE PERIOD ON AND AFTER OCTOBER 31, 1942

Classes of taxpayers	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes over 2 percent of the tax	Corporate bond interest: With tax-free covenant and issued before Jan. 1, 1934: If corporation assumes not over 2 percent of the tax	Corporate bond interest: Without tax-free covenant or issued on or after Jan. 1, 1934, with tax-free covenant	Salary or other compensation for personal services	Other fixed or determinable annual or periodical income, including dividends, from sources within the United States
	Percent	Percent	Percent	Percent	Percent
1. Citizen or resident individual, fiduciary, or partnership	2	2			
2. Nonresident individual, fiduciary, or partnership	2	30	30	[1] 30	[2] 30
3. Domestic corporation or resident foreign corporation					
4. Nonresident foreign corporation	2	30	30	30	[2] 30
5. Nonresident alien, fiduciary, or partnership; resident of Canada, or nonresident corporation organized under the laws of Canada	2	15	15	30	[4] 15
6. Unknown owner	2	30	30		([3])

[1] Salary or compensation for personal services rendered in the United States is not subject to withholding in the case of nonresident aliens, residents of Canada or Mexico, who enter and leave the United States at frequent intervals.
[2] In the case of a resident of Sweden or a corporation or other entity organized under the laws of Sweden, the rate with respect to dividends is 10 percent for at least two years beginning Jan. 1, 1940.
[3] Interest on any noncorporate security the owner of which is unknown to the withholding agent is subject to withholding at the rate of 30 percent.
[4] Such rate was effective June 27, 1942. In the case of dividends within the provisions of Article XI(2) of the tax convention between the United States and Canada, the rate is 5 percent.

SEC. 145. PENALTIES [as amended by secs. 136 (b) (c), 172 (f), Rev. Act 1942; sec. 5 (c), Current Tax Payment Act 1943].

(a) *Failure to file returns, submit information, or pay 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) Any individual who willfully makes and subscribes a return 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 subject to the penalties prescribed for perjury in section 125 of the Criminal Code.

(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) *Cross reference.* (1) For penalties for failure to file information returns with respect to foreign personal holding companies and foreign corporations, see section 340.

(2) For additional penalties for fraudulent receipts or failure to furnish receipts required by section 463, see section 470.

§ 29.145-1 *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 sworn statement required with reference thereto, make such persons subject to the penalties imposed by section 145 (a). An individual who willfully makes and subscribes a return which he does not believe to be true and correct as to every material matter, is guilty of a felony, and, if convicted, may be fined not more than $2,000 and imprisoned not more than five years (see Criminal Code, section 125, 18 U. S. C., 231). The privilege against incrimination in the fifth amendment to the Constitution is not a defense to a charge of failure to file a return, and does not authorize a refusal to state the amount of income, though the taxpayer's income was made through crime.

SEC. 146. CLOSING BY COMMISSIONER OF TAXABLE YEAR.

(a) *Tax in jeopardy*—(1) *Departure of taxpayer or removal of property from United States.* If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any proceeding in court brought to enforce payment of taxes made due and payable by virtue of the provisions of this section the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design.

(2) *Corporation in liquidation.* If the Commissioner finds that the collection of the tax of a corporation for the current or last preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so

declared terminated and of the tax for the last preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable.

(b) *Security for payment.* A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner, with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this section, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress.

(c) *Same; exemption from section.* If security is approved and accepted pursuant to the provisions of this section and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this section prior to the expiration of the time otherwise allowed for paying such respective taxes.

(d) *Citizens.* In the case of a citizen of the United States or of a possession of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this section.

(e) *Departure of alien.* No alien shall depart from the United States unless he first procures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws.

(f) *Addition to tax.* If a taxpayer violates or attempts to violate this section there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 6 per centum per annum from the time the tax became due.

§ 29.146-1 *Termination of the taxable period by Commissioner.* (a) Section 146 provides that in the case of a taxpayer who designs by immediate departure from the United States or otherwise to avoid the payment of the tax for the preceding or current taxable year, the Commissioner may upon evidence satisfactory to him, declare the taxable period for such taxpayer immediately terminated and cause to be served upon him notice and demand for immediate payment of the tax for the taxable period declared terminated, and of the tax for the preceding taxable year, or so much of such tax as is unpaid. In such a case the taxpayer is entitled to the personal exemption and credit for dependents, if otherwise allowable, but the amount allowable as personal exemption and credit for dependents shall be reduced proportionately to the length of the period for which the return is made. If suit is necessary to collect a tax made due and payable by the provisions of section 146 (a) (1), the Commissioner's finding is presumptive evidence of the taxpayer's design. Section 146 (a) (2) provides for a similar termination of the taxable period of a corporation if the Commissioner finds that the collection of the tax of the corporation for the current or last preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock. Such a 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 collector or internal revenue agent in charge. A certificate of compliance is attached to and made a part of Form 1040C. An alien, whether resident or nonresident, who intends to depart from the United States should appear before the collector or internal revenue agent in charge for the district in which he resides and satisfy all income tax obligations with respect to income received or to be received, determined as nearly as may be, up to and including the date of his intended departure. Upon payment of such obligations, or upon the furnishing of such security as may be approved by the Commissioner for the payment of such obligations, or upon satisfactory evidence that no tax is due and payable, the collector or internal revenue agent in charge will issue a certificate of compliance to the applicant. A properly executed certificate of compliance issued by the collector or internal revenue agent must be presented at the point of departure. An alien presenting himself at the point of departure without such certificate of compliance will be examined by an internal revenue officer at that point and such taxes as appear to be due and owing will be collected. Citizens of the United States or of possessions of the United States departing from the United States will not be required to procure certificates of compliance or to present any other evidence of compliance with income tax obligations.

(c) An alien who intends to depart from the United States and whose taxable year has not been terminated by the Commissioner as provided in section 146 (a), and who is not in default in making any return, or paying income, war-profits, or excess-profits tax under any Act of Congress, may procure a certificate of compliance as provided in section 146 (e) by (1) appointing in writing on Form 934 an attorney in fact, resident in the United States, to make his income tax return or returns for the taxable year current at the time of his intended departure and for the next preceding taxable year (if not already made), (2) making on Form 1040D a return of information for his taxable year current at the time of his intended departure and a return on that form for the next preceding taxable year where the period for making the income tax return for the next preceding taxable year has not expired, and (3) either paying the estimated tax as shown on the information return (Form 1040D), which will be credited on account for the year covered by such return, or furnishing security approved by the Commissioner that he will make the required return or returns and pay the tax or taxes required to be paid. If such security is approved and accepted and such further security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes may be postponed until the expiration of the time otherwise allowed for their payment. The departing alien may furnish as security a surety bond on Form 1133 in an amount not exceeding double the amount of tax for his taxable year current at the time of his intended departure, and for the next preceding taxable year (if not already paid), conditioned upon the making of his return or returns for such year or years (if not already made), and the payment of any tax or taxes that may become payable for such year or years together with any penalty and interest that may accrue thereon, such bond to be executed by a surety or sureties approved by the Commissioner. In lieu of such 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 collector or internal revenue agent in charge by signing the Form 1133 as follows:

Commissioner of Internal Revenue.

By ---

(Collector of Internal Revenue.)

(Internal Revenue Agent in Charge.)

A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds. If the surety on the bond is an individual or individuals such bonds shall not be accepted until an investigation is made as to the financial and other responsibility of such surety or sureties and such investigation shows that the collection of the tax is amply secured by the bond.

SEC. 147. INFORMATION AT SOURCE [As amended by sec. 7 (c), Rev. Act 1940; secs. 112 (c), 116 (a) (b), Rev. Act 1941; sec. 131 (c), Rev. Act 1942].

(a) *Payments of $500 or more.* All persons, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another person, of interest, rent,

salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in section 143 (a) or 149), of $500 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

(b) *Returns regardless of amount of payment.* Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, (2) in the case of payments of interest upon obligations of the United States or any agency or instrumentality thereof, and (3) 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.

§ 29.147-1 *Return of information as to payments of $500.* All persons making payment to another person of fixed or determinable income of $500 or more in any calendar year must render a return thereof to the Commissioner for such year on or before February 15 of the following year, except as specified in §§ 29.147-3 to 29.147-5, 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. 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 § 29.143-2.)

Sums paid in respect of life insurance, endowment, or annuity contracts which are required to be included in gross income under §§ 29.22 (b) (1)-1, 29.22 (b) (2)-1, and 29.22 (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.

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.

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.

§ 29.147-2 *Return of information as to payments to employees.* The names of all employees to whom payments of $500 or more are made in any calendar year, whether such total sum is made up of wages, salaries, commissions, or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. Amounts distributed or made available under an employees' trust governed by the provisions of section 165 to any beneficiary in any taxable year, in excess of the sum of his personal exemption and the amounts paid into the fund by him, must be reported by the trustee. But see § 29.147-3. (See also § 29.22 (a)-3.)

In the case of payments made by the United States to persons in its service (civil, military, or naval) of wages, salaries, or compensation in any other form, the returns of information shall be made by the heads of the executive departments and other United States Government establishments.

§ 29.147-3 *Cases where no return of information required.* Payments of the following character, although more than $500 during a calendar year, need not be reported in returns of information on Form 1099:

(a) Payments by a broker to his customers;

(b) Payments of any type made to corporations;

(c) Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges;

(d) 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 $500 or more);

(e) Payments made to alien employees serving in foreign countries or payments representing earned income for services rendered without the United States made to nonresident citizens entitled to the benefits of section 116 (a);

(f) Salaries and profits paid or distributed by a partnership to the individual partners;

(g) Payments of salaries, or other compensation for personal services aggregating less than $1,200 for a calendar year, made to a married individual (citizen or resident);

(h) 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;

(i) Payments of income upon which income tax has been withheld at the source and reported on Forms 1012, 1013, 1042, or Forms V-1, V-2, and V-3; and

(j) Amounts paid by the United States to persons in its service (civil, military, or naval) as an allowance for traveling expenses, including an allowance for meals and lodgings, as, for example, a per diem allowance in lieu of subsistence, and amounts paid as reimbursements for traveling expenses.

If the marital status of the payee is unknown to the payor, or if the marital status of the payee changed during the year (see § 29.25-7), or if the payee is a resident of Canada or Mexico, the payee will be considered a single person for the purpose of filing a return of information on Form 1099 with respect to payments of salaries or other compensation for personal services.

§ 29.147-4 *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 § 29.143-5.) (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 prior to 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 § 29.143-4.)

§ 29.147-5 *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 § 29.3797-8), the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. (See sections 143 and 144.)

§ 29.147-6 *Foreign items.* The term "foreign items," as used in these regulations, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States, or any item of dividends upon the stock of such corporation.

§ 29.147-7 *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 $500 or more. Such forms accompanied by Form 1096 should be forwarded to the Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C., on or before February 15 of each year. The term "collection" includes the following: (a) The payment by the licensee of the foreign item in cash; (b) the crediting by the licensee of the account of the person presenting the foreign item; (c) the tentative crediting by the licensee of the account of the person presenting the foreign item until the amount of the foreign item is received by the licensee from abroad; and (d) the receipt of foreign items by the licensee for the purpose of transmitting them abroad for deposits. (See §§ 29.147-1 and 29.147-3.)

§ 29.147-8 *Information as to actual owner.* 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, Returns Distribution Section, Washington, D. C., not later than February 15 of the succeeding year. Unless such a disclosure is made, the record owner will be held liable for any tax based upon such dividends. (See § 29.148-1.)

The filing of Form 1087 is not required (a) if the record owner is required to file a fiduciary return on Form 1041, or a withholding return on Form 1042, disclosing the name and address of the actual owner or payee, or (b) if the actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the tax has been withheld at the source prior to receipt of the dividends by the record owner. (See § 29.143-1.)

SEC. 148. INFORMATION BY CORPORATIONS [as amended by sec. 407, Rev. Act 1939].

(a) *Dividend payments.* Every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him.

(b) *Profits declared as dividends.* Every corporation shall, when required by the Commissioner, furnish him a statement of such facts as will enable him to determine the portion of the earnings or profits of the corporation (including gains, profits, and income not taxed) accumulated during such periods as the Commissioner may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Commissioner may specify.

(c) *Accumulated earnings and profits.* When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if dividend or distributed, and of the amounts that would be payable to each.

(d) *Contemplated dissolution or liquidation.* Every corporation shall, within thirty days after the adoption by the corporation of a resolution or plan for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock, render a correct return to the Commissioner, verified under oath, setting forth the terms of such resolution or plan and such other information as the Commissioner shall, with the approval of the Secretary, by regulations prescribe.

(e) *Distributions in liquidation.* Every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its distributions in liquidation, stating the name and address of each shareholder, the number and class of shares owned by him, and the amount paid to him or, if the distribution is in property other than money, the fair market value (as of the date the distribution is made) of the property distributed to him.

(f) *Compensation of officers and employees.* Under regulations prescribed by the Commissioner with the approval of the Secretary, every corporation subject to taxation under this chapter shall, in its return, submit a list of the names of all officers and employees of such corporation and the respective amounts paid to them during the taxable year of the corporation by the corporation as salary, commission, bonus, or other compensation for personal services rendered, if the aggregate amount so paid to the individual is in excess of $75,000.

The Secretary shall compile from the returns made a list containing the names of, and the amounts paid to, each such officer and employee and the name of the paying corporation, and shall make such list available to the public. It shall be unlawful for any person to sell, offer for sale, or circulate, for any consideration whatsoever, any copy or reproduction of any list, or part thereof, authorized to be made public by this Act or by any prior Act relating to the publication of information derived from income-tax returns; 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: *Provided,* That nothing in this sentence shall be construed to be applicable with respect to any newspaper, or other periodical publication, entitled to admission to the mails as second-class mail matter.

§ 29.148-1 *Return of information as to payments of dividends.* Section 148 provides that every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him. In accordance with that section, returns of information in respect of dividend payments shall be rendered for each calendar year as follows:

(a) Except as provided in paragraph (b) 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 $100 or more during each calendar year, shall render an information return on Forms 1096 and 1099. A separate Form 1099 must be prepared for each shareholder, upon which will be shown the name and address of the shareholder to whom such payment was made, and the amount paid. These forms, accompanied by a letter of transmittal on Form 1096 showing the number of Forms 1099 filed therewith, shall be filed with the Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C., on or before February 15 of the following year.

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 dividensd 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 will fill in the information on both sides of Form 1096 and forward this form, together with Forms 1099, to the Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C., 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.

(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. The request for the extension of time must be forwarded to the Commissioner of Internal Revenue, Practice and Procedure Division, Washington, D. C., on or before the date prescribed for filing the return.

§ 29.148-2 *Return of information respecting contemplated dissolution or liquidation*—(a) *Making and filing of re-*

turns. 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 Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, a correct return on Form 966, made under oath or affirmation and containing the information required by paragraph (b) of this 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) *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.

§ 29.148-3 *Return of information respecting distributions in liquidation.* Unless the distribution is one in respect of which information is required to be filed pursuant to § 29.112 (b) (6)-5 (b), 29.112 (g)-6 (a), or 29.371-10, every corporation making any distribution of $500 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 these regulations. 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, accompanied by a letter of transmittal on Form 1096 showing the number of Forms 1099L filed therewith, shall be filed with the Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C., on or before February 15 of the year following the calendar year in which such distribution was made.

§ 29.148-4 *Information respecting compensation of officers and employees in excess of $75,000.* Every corporation subject to taxation under chapter 1 which during any taxable year has paid to any officer or employee of the corporation, salary, commission, bonus, or other compensation for personal services rendered, in an aggregate amount in excess of $75,000 (in whatever form paid), shall in respect of each such taxable year, make and file, in duplicate, a schedule on the form prescribed by the Commissioner, as a part of its income tax return, in accordance with the instructions contained in the prescribed return. Such schedule shall contain the following information: (1) Name of officer or employee, (2) amount of salary paid, (3) amount of commission paid, (4) amount of bonus paid, (5) amount of other compensation paid, and (6) total compensation paid.

The term "paid" as used in this section means "paid or accrued" or "paid or incurred" which shall be construed according to the method of accounting upon the basis of which the net income of the corporation is computed.

Upon receipt of the returns by the collector, the schedules will be detached and forwarded by the collector to the Commissioner of Internal Revenue, Records Division, Washington, D. C.

SEC. 149. RETURNS OF BROKERS.

Every person doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such person has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

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.

§ 29.150-1 *License to collect foreign items.* Banks or agents collecting foreign items, as defined in § 29.147-6, and required by § 29.147-7 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Any person holding a license under the Revenue Act of 1938 or any prior Act will not be required to renew such license.

SEC. 151. FOREIGN PERSONAL HOLDING COMPANIES.

For information returns by officers, directors, and large shareholders, with respect to foreign personal holding companies, see sections 338, 339, and 340.

For information returns by attorneys, accountants, and so forth, as to formation, and so forth, of foreign corporations, see section 3604.

ESTATES AND TRUSTS

SEC. 161. IMPOSITION OF TAX.

(a) *Application of tax.* The taxes imposed by this chapter 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.

§ 29.161-1 *Imposition of the tax*—(a) *Scope.* Supplement E (sections 161 to 172, inclusive) prescribes that the taxes imposed upon individuals by chapter 1 shall be applicable to the income of estates or of any kind of property held in trust. The rate of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trusts.

The several classes enumerated and described in the four paragraphs of sec-

tion 161 (a), and which are introduced by the word "including," do not exclude others which also may come within the general purpose of that subsection.

A guardian, whether of an infant or other person, is a fiduciary (see section 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 §§ 29.51-1 and 29.142-2.) The estate of a ward is not a taxable entity, in that respect differing from the estate of a deceased person or of a trust.

The provisions of sections 161, 162, and 163 (relating to estates and trusts, fiduciaries, and beneficiaries) contemplate that the corpus of the trust, or the income therefrom, is, within the meaning of the 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 in contemplation of law the corpus of the trust or the income therefrom is regarded as remaining in substance that of the grantor are likewise excluded from the scope of sections 161, 162, and 163. Some of such trusts are dealt with in §§ 29.166-1 and 29.167-1. 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 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 165, 166, and 167, and §§ 29.166-1 and 29.167-1. In determining whether there is any net income subject to tax and the amount thereof, consideration is to be given to the additional deductions authorized in section 162.

SEC. 162. NET INCOME [as amended by secs. 111(b)(c), 161(a), Rev. Act 1942].

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23(o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the 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 cementery not operated for profit;

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the 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.

(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).

SEC. 111. INCOME RECEIVED FROM ESTATES, ETC., UNDER GIFTS, BEQUESTS, ETC. (Revenue Act of 1942.)

* * * * *

(e) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1941; except that in the case of income paid, credited or to be distributed or amounts paid, credited or to be distributed by an estate or trust the amendments made by this section shall be applicable only with respect to such income and such amounts paid, credited or to be distributed on or after the beginning of the first taxable year of the estate or trust, as the case may be, beginning after December 31, 1941.

§ 29.162-1 *Income of estates and trusts.* In ascertaining the tax liability of the estate of a deceased person or of a trust, there is deductible from the gross income, subject to exceptions, the same deductions which are allowed to individual taxpayers. See generally section 23, and the provisions thereof governing the right of deduction for depreciation and depletion in the case of property held in trust. 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 with the return in

which the item is claimed as a deduction 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). For items not deductible, see section 24. Against the net income of the estate or trust there are allowable certain credits, for which see sections 25 and 163.

From the gross income of the estate or trust there are also deductible (either in lieu of, or in addition to, the deductions referred to in the preceding paragraph of this section) the following:

(a) 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.

(b) 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.

(c) Any income of the estate of a deceased person for its taxable year which is properly paid or credited during such year to a legatee or heir, and any income either of such an estate or of a trust for its taxable year which is similarly paid or credited during that year to a legatee, heir, or beneficiary if there was vested in the fiduciary a discretion either to distribute or to accumulate such income.

Any income of the class described in either (b) or (c) of this section, which is currently distributable, or paid or credited, to a guardian for his ward is likewise deductible from the gross income of the estate or trust.

There is included in the income of the estate or the trust, unless it is included in the income of the grantor of the trust (see §§ 29.166-1 and 29.167-1):

(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 (b) 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 (c) 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 taxable to the grantor of the trust or where, as provided in the next paragraph, it is deductible by the estate or trust for such taxable year (and is includible in the income of the legatee or beneficiary).

Income described in subparagraphs (1), (2), (4), and (5) of paragraph (c) may, in some cases, be deductible by the estate or trust under (b) 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, 1942, the income of the trust (assuming the income tax returns of the trust are made on the calendar year basis) for the calendar year 1942 is to be deducted by the trust under section 162 (b) in computing its net income for 1942 and is to be included in the income of A for his taxable year in which December 31, 1942, falls. In the case of a similar trust, where the twenty-first birthday of B, the beneficiary, was on July 1, 1942, 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, 1942, decides to distribute the accumulated income to B, the income becomes payable to B on December 31, 1942, 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 § 29.162-2 (b).

Any amount described in (b) and (c) 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 (b) and (c) of this section and the inclusion in income of the legatee, heir, or beneficiary, see section 162 (d) and § 29.162-2.

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 §§ 29.167-1, 29.171-1, and 29.171-2.)

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 § 29.162-2 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.

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 any 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 such income, to the extent it becomes payable in a subsequent taxable year of the estate or trust to the distributee after the first 65 days of such subsequent taxable year, may be required to be included in the income of the distributee under section 162 (d) (2). See § 29.162-2 (b)

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.

§ 29.162-2 *Allocation of estate and trust income to legatees and beneficiaries*—(a) *Allocation among annuitants.*

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.

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.

Section 162 (d) (1) introduces a concept of distributable income. This is defined in that section as meaning (1) 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 (2) 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. 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, 1942, to pay $5,000 a year to B in quarterly installments at the end of every three months, 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 1942 are as follows:

Taxable stock dividend	$1,000
Income from rents	3,000
Tax-exempt interest from State bonds	1,000
Gain from sale of capital asset held 10 months	1,000
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, gain from sale of a capital asset held not more than one year is to be allocated to income, 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 1942 and included in the beneficiary's income for such year is $3,300, the greater of the statutory net income and 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	
Long-term capital gain (50 percent taken into account, section 117 (b))	500	
		$4,500
Deductions:		
Trustees' commissions	200	
Other deductible expenses	1,300	
		1,500
Net income		3,000

Trust Income Under Clause (B) of Section 162 (d) (1)

Income:		
Rents	$3,000	
Interest from State bonds	1,000	
Gain on sale of asset	1,000	
		$5,000
Expenses allocated to income:		
Trustee's commissions	200	
Eliminating items not includible in gross income:		
Tax-exempt interest	1,000	
Excluded gain on sale of asset	500	
		1,700
Income determined under section 162 (d) (1) (B)		3,300

"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 1925, 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, 1942. 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 1942 on and before June 30, 1942, is to be considered income of the trust for 1942 which is to be distributed currently to A. In computing the distributable income of the trust for 1942 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 1942 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, 1941, through June 30, 1942, will be considered income of the trust for 1942 which is to be deducted by the trust and included in A's income for 1942 (see paragraph (b) of this section), for the purposes of section 162 (d) (1) such amount is not to be deducted from the trust's income for 1942 in computing its distributable 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, 1941, through December 31, 1941.

(b) *Allocation among income beneficiaries and legatees.* 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 bene-

ficiary 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), 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. The rule stated in the preceding sentence, 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).

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.

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.

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 accumulated and the beneficiary has no right to such income until the last day of such period (June 30). For the purpose of the tax for 1941, the entire gross income received by the trust in 1941 is required to be included in its income for 1941, and, under the law applicable to 1941, the 1941 trust income distributable on June 30, 1941, is allowed as a deduction, but the 1941 trust income not distributable until June 30, 1942, is not allowable as a deduction for 1941. For the purpose of the tax for 1942, the entire gross income received by the trust in 1942 will be included in its income for 1942. Under section 162 (d) (2), the trust income for the 12 months ending June 30, 1942, which under the terms of the trust instrument, is available for distribution on such date, will be considered for the purposes of section 162 (b) as income for the taxable year 1942 which becomes payable on June 30, 1942, and, accordingly, will be deducted by the trust for 1942. Assuming the beneficiary makes his income tax returns on the calendar year basis, he will include this amount deducted by the trust in 1942 in his income for 1942. The same process will be repeated each year thereafter as long as the accounting periods and the distribution date remain the same. Thus, if, in such a case, the entire net income of the trust (determined before the application of section 162 (b)) is available for distribution and the trust receives each month $100 of such income available for distribution, for 1941 the trust will have $600 of taxable net income (before credits), that is, the excess of the $1,200 income over the $600 deduction for the June 30, 1941, distribution. For the taxable year ended December 31, 1942, the trust will include $1,200 in its income, which is its actual income for 1942 determined under section 161 without inclusion of that part of the 1941 income distributed on June 30, 1942, and without exclusion of that part of the 1942 income distributable on June 30, 1943. Assuming that the income distributable on June 30, 1942, is not to be reduced under the trust instrument and State law by the amount of tax paid by the trust with respect to the 1941 income included in such distribution, the trust will be allowed a deduction in computing its tax for 1942 of the whole $1,200 which becomes payable on June 30, 1942, and which is included in the beneficiary's income for 1942. Thus, for 1942 the trust will pay no income tax and the beneficiary will include $1,200 in computing his net income.

Example (2). An estate which came into being on January 1, 1941, accumulates the income received (as is allowed under the local law) until June 30, 1942, 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, 1942, 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 1942, the distribution on June 30, 1942, 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 1942, and the final distribution of $18,000 on December 31, 1942, 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 1942 and the most recently accumulated income is the $6,000 for the last six months of 1942. Accordingly, for 1942 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, 1942.

Example (3). Under the terms of the will of X, who died in 1940, after payment of expenses and specific bequests, the residue of his estate (which will include the undistributed income for the period of administration) is to be divided into two equal shares and one of such shares is to be paid over to his widow and the other such share is to be paid over to a testamentary trust for the benefit of his children. During the period of administration, the estate makes its returns on the calendar year basis. The administration of the estate is terminated on June 30, 1942, at which date equal shares of the principal and the income (which under the local law first became payable at such date) are transferred in accordance with the terms of the will to the widow and to a trust established as of such date. With the application of section 162 (d) (2) the widow and the trust will each include in their income tax returns filed for their first taxable years ending on or after June 30, 1942, one-half of the income of the estate for the 12 months preceding June 30, 1942. This distribution will include the income of the estate for the last six months of 1941 upon which the estate may already have paid tax for 1941, but such income may, if under the local law the Federal income tax is a charge against such income, be reduced by the amount of Federal income tax attributable to such income and paid for 1941 by the estate. The return of the estate for 1942 will show a deduction of the amount of the income for the 12 months preceding June 30, 1942, which is includible in the income of the widow and the testamentary trust.

The rule 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, 1941, 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 1941 accumulated income to be distributed in 1942 will be considered income of the trust for 1942 which is to be distributed in 1942.

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 cur-

rent taxable year. This rule may be illustrated by the following example:

Example. Under the terms of a testamentary trust, established in 1920, the income of the trust is to be accumulated until B, the beneficiary, reaches his twenty-first birthday, which is June 30, 1942, and then is to be distributed along with the corpus of the trust at such time as the trustee thereafter decides; the income of the trust after June 30, 1942, and until such time as the trustee decides to distribute the accumulated income and corpus to B is to be given to C. The returns of the trust are made on the calendar year basis. On December 31, 1942, the trustee decides to distribute to B, as of that date, the corpus and the income accumulated to June 30, 1942. Under section 162 (d) (2), the amount of accumulated income of the trust for the period July 1, 1941, through June 30, 1942 (the last 12 months of the period of accumulation), which becomes payable on December 31, 1942, is to be included in B's income. The amount of income of the trust for the period July 1, 1942, through December 31, 1942, is to be included in C's income. The trust will deduct such amounts under section 162 (b) in computing its taxable net income for 1942.

(c) *Distributions in first 65 days of taxable year.* 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.

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, 1943, is considered to begin 12 months preceding December 31, 1942 since the part of the interval not falling within the taxable year 1943 (March 2, 1941, through December 31, 1942) is more than 12 months. Accordingly, the interval is considered to be the period January 1, 1942, through March 1, 1943, or 425 days, and the part of the interval not falling within the taxable year is considered to be the calendar year 1942, or 365 days. Therefore, of the $4,250 which becomes payable on March 1, 1943, 365/425 of such amount, or $3,650, is considered to be an amount to be distributed on December 31, 1942. 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.

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 perceding 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, 1942, through February 28, 1943, or a total of $6,000. In such case, $1,000 of the $5,000 to be distributed to the beneficiairy on February 28, 1943, will be considered to be distributed out of the income of the trust for 1943 (the income of the period January 1, 1943, through February 28, 1943) and $4,000 will be considered to have been distributed to the beneficiary on December 31, 1942, out of the income of the trust for 1942.

Any amount paid, credited, or to be distributed within the first 65 days of any taxable year of the estate or trust beginning after December 31, 1941, and which is allocated under section 162 (d) (3) to the last day of a taxable year beginning before January 1, 1942, is not to be reflected in the returns of the estate or trust and of the legatee or beneficiary as a deduction or as income, as the case may be, for the taxable year in which such amount is actually paid, credited, or to be distributed.

SEC. 163. CREDITS AGAINST NET INCOME [as amended by sec. 126 (d), Rev. Act 1942].

(a) *Credits of estate or trust.* (1) For the purpose of the normal tax and the surtax an estate shall be allowed the same personal exemption as is allowed to a single person under section 25 (b) (1), and a trust shall be allowed (in lieu of the personal exemption under section 25 (b) (1)) a credit of $100 against net income.

(2) If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, then the estate or trust shall be allowed the same credits against net income for interest as are allowed by section 25 (a).

(b) *Credits of beneficiary.* If any part of the income of an estate or trust is included in computing the net income of any legatee, heir, or beneficiary, such legatee, heir, or beneficiary shall, for the purpose of the normal tax, be allowed as credits against net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts of interest specified in section 25 (a) as are, under this Supplement, required to be included in computing his net income. Any remaining portion of such amounts specified in section 25 (a) shall, for the purpose of the normal tax, be allowed as credits to the estate or trust.

(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.

§ 29.163-1 *Credits to estate, trust, or beneficiary*—(a) *Personal exemption allowed estates and trusts.* An estate is allowed for both normal tax and surtax purposes the personal exemption allowed a single person under section 25 (b) (1). For proration of the personal exemption in the case of a taxable year of less than 12 months, see §§ 29.25-7 and 29.47-1. A trust is allowed for both normal tax and surtax purposes a credit of $100 against net income. A credit for dependents is not allowable to an estate or trust.

(b) *Credit for interest to estate or trust.* If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, the estate or trust shall be allowed the credits provided in section 25 (a), in respect of interest upon certain obligations of the United States. (For reduction of credits on account of amortizable bond premium, see § 29.125-9.)

(c) *Credit for interest to beneficiary.* If any part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, he is allowed for the purpose of the normal tax, in addition to his individual credits, the proportionate share of the interest upon obligations of the United States and instrumentalities of the United States which is exempt from normal tax only and is required to be included in computing net income. Any remaining portion of such interest will be allowed as a credit for the purpose of the normal tax to the estate or trust. Where the amount of the interest specified in section 25 (a) is in excess of the net income of the estate or trust, the proportionate share of such interest which each beneficiary is required to include in computing his net income and for which he is allowed a credit for normal tax purposes is an amount equal to his distributive share of the net income of the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. (See section 25.) (For reduction of credits on account of amortizable bond premium, see § 29.125-9.)

SEC. 164. DIFFERENT TAXABLE YEARS [as amended by sec. 111 (d), Rev. Act 1942].

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. 111. INCOME RECEIVED FROM ESTATES, ETC., UNDER GIFTS, BEQUESTS, ETC. (Revenue Act of 1942, Title I.)

* * * * *

(e) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1941; except that in the case of income paid, credited or to be distributed or amounts paid, credited or to be distributed by an estate or trust the amendments made by this section shall be applicable only with respect to such income and such amounts paid, credited or to be distributed on or after the beginning of the first taxable year of the estate or trust, as the case may be, beginning after December 31, 1941.

SEC. 165. EMPLOYEES' TRUSTS [as amended by sec. 218, Rev. Act 1939; sec. 162 (a), Rev. Act 1942].

(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 paragraphs (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.

(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.

SEC. 162. PENSION TRUSTS. (Revenue Act of 1942, Title I.)

* * * * *

(d) *Taxable years to which amendments applicable.* The amendments made by this section shall be applicable as to both the employer and employees only with respect to taxable years of the employer beginning after December 31, 1941, except that—

(1) In the case of a stock bonus, pension, profit-sharing, or annuity plan in effect on or before September 1, 1942,

(A) such a plan shall not become subject to the requirements of section 165 (a) (3), (4), (5), and (6) until the beginning of the first taxable year beginning after December 31, 1942,

(B) such a plan shall be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the beginning of the first taxable year following December 31, 1942, and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943,

* * * * *

(2) In the case of a stock bonus, pension, profit sharing or annuity plan put into effect after September 1, 1942, such a plan shall be considered as satisfying the requirements of section 165 (a) (3), (4), (5) and (6) for the period beginning with the date such plan is put into effect and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943.

§ 29.165-1 *Employees' trusts*—(a) *In general.* 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.

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 Commissioner, stating the circumstances which led to the discontinuance of the plan.

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). 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.

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.

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 the Commissioner may determine 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 § 29.165-3. 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 collector of the district in which the employer files his return: (1) An affidavit showing its character, purpose, activities, sources and disposition of corpus and income, and every fact which might affect its status for exemption; (2) verified copies of the trust instrument and of the employer's plan, showing all amendments; (3) the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the trust; and (4) the information required under § 29.23(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).

The collector upon receipt of the affidavit and other papers will forward them to the Commissioner for decision as to whether the trust is exempt. The information required in the preceding paragraph must be filed for each taxable year of the trust with respect to which this section is applicable, but the documents or information mentioned in (1) and (2) of paragraph (c) need not be filed with respect to other than the first of such taxable years, except when necessary to show changes occurring since the last filing.

§ 29.165-2 *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 actuarial 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.

§ 29.165-3 *Requirements as to coverage.* 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). See § 26.165-5 as to the effective date 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. 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:

1. Total employees with respect to which the percentage requirements are applicable (1,000 minus (100 plus 50 plus 25))	825
2. Employees not eligible to participate because of age requirements	150
3. Total employees eligible to participate	675
4. Percentage of employees in item 1 eligible to participate	.81+
5. 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.

If a plan fails to qualify under the percentage requirements of section 165 (a) (3) (A), it may still qualify under subparagraph (B) of such section provided always that (as required by paragraphs (3) and (4) of section 165 (a)) 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.

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 requirement 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.

Section 165 (a) (5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of subparagraph (B) merely because there are excluded from the plan employees whose annual remuneration is $3,000 or less and as to which the Social Security Act applies. This provision, in conjunction with subparagraph (B), is intended to permit plans to qualify which supplement the social security program. A classification which excludes all employees the whole of whose remuneration constitutes wages under section 1426 (a) (1) (relating to the Federal Insurance Contributions Act), 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 such law 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 such law or under such law 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 subparagraph (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 earning $3,000 per annum or less 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).

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).

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).

§ 29.165-4 *Discrimination as to contributions or benefits.* 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. However, 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 § 29.165-3.) 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 the first $3,000 of 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 $3,000. 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.

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).

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.

§ 29.165-5 *Effect of amendments to section 165 (a) on old and new stock bonus, pension, profit-sharing, and annuity plans.* Section 162 (d) of the Revenue Act of 1942 (set forth immediately preceding § 29.165-1) makes the requirements of section 165 (a) (3), (4), (5), and (6) inapplicable for taxable years beginning prior to January 1, 1943, in the case of a stock bonus, pension, profit-sharing, or annuity plan in effect on or before September 1, 1942. In such cases, for such taxable years a trust will be exempt if it complies with section 165 (a) (1) and (2), except that for taxable years beginning prior to January 1, 1940, it need not comply with section 165 (a) (2). The provisions of § 19.165-1 of this chapter are applicable in such a case to a taxable year beginning after December 31, 1941, and prior to January 1, 1943. A plan which requires the use of a trust is not in effect as of September 1, 1942, if there was no valid trust in existence at that time. A plan requiring the purchase of an annuity or insurance contract or contracts is not in effect as of September 1, 1942, if there is no such contract or contracts in effect at that time.

In the case of a plan in effect on or before September 1, 1942, the plan will be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the beginning of the first taxable year following December 31, 1942, and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943. Thus, if an employer having such a plan in effect makes a return on the basis of the calendar year, he will have until December 31, 1943, to amend his plan so as to make it satisfy such requirements for the calendar year 1943. Also, if he is on a fiscal year basis he will have until December 31, 1943, to amend his plan with respect to a taxable year beginning after December 31, 1942.

In the case of plans not in effect on or before September 1, 1942, section 165 is applicable to all taxable years beginning after December 31, 1941. However, if such a plan satisfies the requirements of section 165 (a) (3), (4), (5), and (6) by December 31, 1943, it shall be considered as satisfying such requirements for the period beginning with the date such plan is put into effect and ending December 31, 1943.

§ 29.165-6 *Taxability of beneficiary under a trust which meets the requirements of section 165 (a).* Section 165 (b) and (c) 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 contributions in his income except in the year or years in which such contributions are distributed or made available to him. 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.

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.

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). 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).

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 taken into account to the extent provided in section 117 (b). As to adjustments if the trust was not exempt for one or more taxable years prior to the year of distribution, see the first paragraph of this section.

§ 29.165-7 *Treatment of beneficiary of a trust not exempt under section 165 (a).* 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. 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 employee'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.

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.

§ 29.166-1 *Trusts with respect to the corpus of which the grantor is regarded as remaining in substance the owner*—(a) *Scope.* If the grantor of a trust is regarded, within the meaning of the Internal Revenue Code, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor, 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.

(b) *Test of taxability to grantor.* Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this 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:

(1) Whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend, or to appoint;

(2) Whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(3) The time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(4) Whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both;

(5) When the trust was created.

But the provisions of section 166 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

In determining whether the grantor is in substance the owner of the corpus, the Internal Revenue Code has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: The fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstance bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

Thus, the grantor is regarded as being in substance the owner of the corpus if, in any case, the trust amounts to no more than an arrangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of certain of his property to a trustee, the income from such property to be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust, an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

Example. A grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John.

(A) For the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) For the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) For the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or

amendment thereof, resulting in the designation of the grantor as distributee.

If, however, the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the owner of the corpus, the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162, and 163.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) *Income and deductions.* If the grantor is regarded as remaining in substance the owner of the corpus, except as provided in sections 22 (k), 23 (u), and 171, the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

SEC. 167. INCOME FOR BENEFIT OF GRANTOR. (a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question."

§ 29.167-1 *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.* 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.

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.

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) or 171) regardless of:

(1) Whether it may be distributed currently or accumulated for future distribution;

(2) Whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) Whether, if such distribution is in any way 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;

(4) The time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(5) When the trust was created.

Thus, the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the trust income. If, for example, trust income is applied in satisfaction of the grantor's legal obligation whether to pay a debt, to support dependents, to pay alimony, to furnish maintenance and support, or otherwise, such income is in all cases taxable to the grantor, except where it is expressly required by section 22 (k) or 171 to be included in the gross income of a wife or a former wife.

If the grantor strips himself permanently and definitely of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor but is taxable as provided in sections 161 and 162.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the income. There is to be excluded in computing the net income of the grantor only that part of the trust income in the disposition of which such person has a substantial interest adverse to the grantor.

(c) *Income and deductions.* If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled to had such income been distributable currently to him.

SEC. 168. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as credit against the tax the beneficiary of an estate or trust to the extent provided in section 131.

SEC. 169. COMMON TRUST FUNDS [as amended by secs. 126 (e), 150 (f), Rev. Act 1942].

(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, subchapters 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 proportion 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.

(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.

§ 29.169-1 *Common trust fund defined.* Under section 169 two conditions must be satisfied by a fund maintained by a bank (as defined in section 104) before such fund may be designated as a "common trust fund." These conditions are that such fund must be maintained by such a bank:

(a) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, whether acting alone or in conjunction with one or more co-fiduciaries, but solely in its capacity: (1) as a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (2) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (3) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual or of an absent individual; and

(b) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

Except as otherwise provided in this section and §§ 29.169-2 to 29.169-5, inclusive, the term "participant" refers to any trust or estate, the moneys of which have been contributed to the common trust fund.

§ 29.169-2 *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 § 29.169-3, 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 § 29.169-3, 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 § 29.169-3.

(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 § 29.125-9.) 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) 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.

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. The provisions of this paragraph may be illustrated by the following example:

Example. The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary net income, 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

The participants' shares of ordinary net income are as follows:

PARTICIPANTS' SHARES OF ORDINARY NET INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75			125
D	50				50
E		75			75
F			50	100	150
G			50	100	150
Total	200	300	200	400	1,100

The participants' shares of 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

The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

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

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 deter-

mining 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.

§ 29.169-3 *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.

§ 29.169-4 *Admission and withdrawal of participants from the common trust fund*—(a) *Gain or loss.* The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 117 (b) are unaffected by such an admission or withdrawal. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of subdivision (c) (7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, effective December 31, 1937, for the benefit of all the then participants in the common trust fund. 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 12 CFR 206.17 (c) (7). 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 prior to January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

§ 29.169-5 *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 § 29.169-2. A copy of the plan of the common trust fund must be filed with the return. If, however, a copy of such plan has once been filed with a return, it need not again be filed if the return contains a statement showing when and where it was filed. If the plan is amended in any way after such copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment was made. Each such return shall be sworn to in the same manner as the return filed by the bank under section 52.

SEC. 170. NET OPERATING LOSSES [as added by sec. 211 (c), Rev. Act 1939].

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.

§ 29.170-1 *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 § 29.166-1 (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 § 29.189-1 in the case of partners.

SEC. 171. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC. [As added by sec. 120 (c), Rev. Act 1942].

(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. [NOTE: Under section 120 (g) of the Revenue Act of 1942 section 171 is applicable "only with respect to taxable years beginning after December 31, 1941; except that if the first taxable year beginning after December 31, 1941, of the husband does not begin on the same day as the first taxable year beginning after December 31, 1941, of the wife, such amendments shall first become applicable in the case of the husband on the first day of the wife's first taxable year beginning after December 31, 1941, regardless of the taxable year of the husband in which such day falls."]

§ 29.171-1 *Income of trust in case of divorce, etc*—(a) *In general.* 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 § 29.171-2 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:

(1) Which is paid, credited or to be distributed to the wife in a taxable year of the wife, and

(2) 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.

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).

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.

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 § 29.22 (k)-1 (d).

§ 29.171-2 *Application of trust rules to alimony payments.* 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.

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, 1942, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1943. Although the periodic payment is received by the wife in 1943, since under sections 162 and 164 the $4,000 income distributable on December 31, 1942, is to be included in the wife's income for 1942, the $1,000 payment out of corpus is to be included in her income for 1942.

SEC. 172. ALLOWANCE OF AMORTIZATION DEDUCTION [as added by sec. 155 (g), Rev. Act 1942].

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 fidu-

ciary under regulations prescribed by the Commissioner with the approval of the Secretary.

§ 29.172-1 *Amortization of emergency facility of estate or trust.* In the case of an emergency facility, as defined in section 124 (e), acquired or completed by an estate or trust after December 31, 1939, 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 124 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 § 29.23 (l)-1.

PARTNERSHIPS

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

§ 29.181-1 *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).

SEC. 182. TAX OF PARTNERS [as amended by sec. 150 (g), Rev. Act 1942].

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).

§ 29.182-1 *Distributive share 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 the husband and wife domiciled in a community property State, and the husband only is a member of a partnership, the part of his distributive share of 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.

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME [as amended by sec. 150 (g), Rev. Act 1942].

(a) *General rule.* The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual except as provided in subsections (b) and (c).

(b) *Segregation of items*—(1) *Capital gains and losses.* There shall be segregated the 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.

§ 29.183-1 *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), 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.

SEC. 184. CREDITS AGAINST NET INCOME [as amended by sec. 162 (f), Rev. Act 1942].

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.

§ 29.184-1. *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 § 29.125-9.)

SEC. 185. EARNED INCOME.

In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership.

§ 29.185-1 *Earned income credit of partners.* For the purpose of computing the earned income credit against net income (see section 25 (a) (3) and (4)), a member of a partnership is entitled to treat a proper part of his distributive share of the partnership net income as earned income. Such part cannot exceed a reasonable allowance as compensation for personal services actually rendered by the partner in connection with the partnership business. In the case of a partnership which is engaged in a trade or business in which capital is a material income-producing factor and in the trade or business of which the partner renders personal services which are material to the earning of the partnership income, the earned income of the partner from the partnership is a reasonable allowance as compensation for the personal services actually rendered by him, but not in excess of 20 percent of his share of the net profits of the partnership (computed without deduction for so-called salaries to members). In such a case, if reasonable compensation is less than 20 percent of the partner's share of the net profits, the earned income is the full amount of the reasonable compensation,

but, if reasonable compensation is more than 20 percent of the partner's share of the net profits, then the earned income is 20 percent of the partner's share of such profits.

There must be included in the return of the partnership a statement showing the names of the members and the amount (determined in accordance with the first paragraph of this section) of each partner's distributive share of the partnership net income which consists of earned income.

Example. A partnership composed of A, B, and C is engaged in the retail men's clothing business. Each partner is entitled to one-third of the net profits, after deduction of so-called salaries to members. A devotes most of his time to the business and is paid a salary of $10,000. B devotes half of his time to the business and is paid a salary of $5,000. C devotes none of his time to the business and receives no salary. The net profits of the partnership for the taxable year, computed without deduction for so-called salaries to members, are $24,000. The earned income of the partners from the partnership is as follows: Although A received a salary of $10,000 and B a salary of $5,000, since the partnership is engaged in a business in which capital is a material income-producing factor, the earned income of each from the partnership is limited to 20 percent of his share of the net profits. A's share of the net profits is $13,000 ($10,000 (salary) + $3,000 (1/3 of net profits after deduction of $15,000 for salaries)). Twenty percent of $13,000 is $2,600, to which amount A's earned income from the partnership is limited. Since B's share of the net profits is $8,000 ($5,000 + $3,000), 20 percent thereof, or $1,600, is B's earned income from the partnership. C has no earned income from the partnership, since he renders no personal services in connection with the partnership business.

SEC. 186. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

The amount of income, war-profits, and excess profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this 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 return shall be sworn to by any one of the partners.

§ 29.187-1 *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 be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year, as the case may be), irrespective of the taxable years of the partners. (See sections 182 and 183.) If the partnership makes any change in its accounting period, it shall make its return in accordance with the provisions of section 47, except that the return shall not be placed on an annual basis under section 47 (c).

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 [as added by sec. 211 (d), Rev. Act 1939.]

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.

§ 29.189-1 *Net operating loss deduction in the case of partners.* 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 following exceptions and limitations:

(a) *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 without regard to the percentage provisions of section 117 (b). 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 or 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 or 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 or losses and such non-business gains or 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.* After excluding all items required to be segregated by (1) and (2) above, there shall be computed:

(i) A business ordinary net income of the partnership, which shall consist of the excess of the business gross income over the business deductions; or

(ii) A business ordinary net loss of the partnership, which shall consist of the excess of the business deductions over the business gross income; and

(iii) A nonbusiness ordinary net income of the partnership, which shall consist of the excess of the nonbusiness gross income over the nonbusiness deductions; or

(iv) 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.

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.

(b) *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 gains and losses from sales or exchanges of capital assets of the partnership shall be taken into account without regard to the percentage provisions of section 117 (b).

SEC. 190. ALLOWANCE OF AMORTIZATION DEDUCTION [as added by sec. 155 (h), Rev. Act 1942].

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.

§ 29.190-1 *Amortization of emergency facility of partnership.* In the case of an emergency facility, as defined in section 124 (e), acquired or completed by a partnership after December 31, 1939, 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 124 and the regulations thereunder. Amortization deductions with respect to an emergency facility of a partnership are not allowed to the members of the partnership.

INSURANCE COMPANIES

SEC. 202. LIFE INSURANCE COMPANIES [as amended by sec. 203, Rev. Act 1939; sec. 163 (a), Rev. Act 1942].

(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 at the rates provided in section 13 or section 14 (b) and in section 15 (b).

(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 noncancellable 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 or 203 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).

§ 29.201-1 *Tax on life insurance companies.* 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 or section 14 (b) and in section 15 (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 § 29.201-9. Such companies are not subject to the provisions of section 117 (capital gains and losses) nor to the provisions of section 125 (amortizable bond premiums). 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 §§ 29.202-1, 29.202-2 and 29.203-1.

All provisions of the Internal Revenue Code and of these regulations not inconsistent with the specific provisions of sections 201 to 203, 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 penalites as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

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.

§ 29.201-2 *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.

§ 29.201-3 *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 shall continue to be taxed under section 201 for taxable years beginning prior to January 1, 1944. For taxable years beginning after December 31, 1943, any such 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 § 29.3797-7.

§ 29.201-4 *Life insurance reserves*. 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.

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.

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.

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.

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.

§ 29.201-5 *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 § 29.202-1). Interest paid consists of (1) 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 (2) 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 § 29.201-4 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 contingenices. 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.

§ 29.201-6 *Adjusted reserves.* For the purpose of determining the figure to be proclaimed by the Secretary under the formula set forth in section 202 (b), certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent (see § 29.202-1). 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.

§ 29.201-7 *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.* The term "general expenses" as used in the Internal Revenue Code 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.

If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses actually paid during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

Invested assets for the purpose of section 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.

Wages or salaries included in investment expenses shall be disallowed as a deduction if determined by the National War Labor Board, the Secretary of Agriculture, or the Commissioner to have been made in contravention of the Act of October 2, 1942 (56 Stat. 765, 5 U.S.C., Sup. 961), entitled "An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes," or of the regulations, orders, or rulings promulgated thereunder.

(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 § 29.201-8.

(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).

§ 29.201-8 *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.

§ 29.201-9 *Amortization of premium and accrual of discount.* 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, (a) the gross income, (b) the deduction for wholly tax-exempt interest, and (c) the credit for partially tax-exempt interest.

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.

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 taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the company (including a company which followed a different method in taxable years beginning prior to January 1, 1942) initiates on or before March 15, 1943, or 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.

The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) 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.

SEC. 202. ADJUSTED NORMAL-TAX NET INCOME [as amended by sec. 163 (a), Rev. Act 1942].

(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 in accordance with the following formula: The ratio which (1) 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 (2) 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).

(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.

§ 29.202-1 *Reserve and other policy liability credit for adjusted normal tax net income*. 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.

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 has gross income, consisting of interest and rents, of $4,000,000, of which $700,000 consists of wholly tax-exempt interest. It has 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 is accordingly $3,100,000 ($4,000,000 less investment expenses, real estate expenses, and depreciation amounting to $200,000 and wholly tax-exempt interest of $700,000). Since the Secretary has 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 is 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 is $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 it 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).

§ 29.202-2 *Adjustment for certain reserves*. 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. The term "unearned premiums" when used in this section has the same meaning as in section 204 (b) (5) and the regulations thereunder.

SEC. 203. ADJUSTED CORPORATION SURTAX NET INCOME [as amended by sec. 211 (e), Rev. Act 1939; sec. 163 (a), Rev. Act 1942].

(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 figure determined and proclaimed under section 202 (b).

§ 29.203-1 *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 § 29.202-1 for the application and effect of this provision.

SEC. 204. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL [AND MUTUAL MARINE INSURANCE COMPANIES] [as amended by secs. 204, 226 (a), Rev. Act 1939; secs. 124 (b), 160 (d), 164, Rev. Act 1942].

(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 taxes at the rates specified in section 13 or section 14 (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, the normal-tax net income shall be the net income from sources within the United States minus the credit provided in section 26 (a), the credit provided in section 26 (b), and the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) 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) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e).

(3) *No United States insurance business*. Foreign insurance companies (other than a

life or mutual insurance company) and foreign mutual marine 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 income, etc.* In the case of an insurance company subject to the tax imposed by this section—

(1) *Gross income.* "Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under section 22;

(2) *Net income.* "Net income" means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section;

(3) *Investment income.* "Investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) *Underwriting income.* "Underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) *Premiums earned.* "Premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year. 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. 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).

§ 29.204-1 *Tax on insurance companies other than life or mutual and mutual marine insurance companies.* 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 are subject to the tax imposed by section 204. The term "insurance companies" as used in this section and §§ 29.204-2 and 29.204-3 means only those companies subject to the tax imposed by section 204. For what constitutes an insurance company, see § 29.3797-7. 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).

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.

Insurance companies are subject to both normal tax and surtax. The normal tax shall be at the rate specified in section 13 (b) if the company has a normal-tax net income of more than $25,000, or at the rate specified in section 14 (b) if it has a normal-tax net income of not more than $25,000. For what constitutes normal-tax net income, see § 29.13-1. The surtax shall be at the rate specified in section 15 (b) (1) if the company has a corporation surtax net income of not more than $25,000, at the rate specified in section 15 (b) (2) if it has a corporation surtax net income of more than $25,000 and not more than $50,000, or at the rate specified in section 15 (b) (3) if it has a corporation surtax net income of more than $50,000. For what constitutes corporation surtax net income, see § 29.15-1. 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.

§ 29.204-2 *Gross income of insurance companies other than life or mutual and mutual marine insurance companies.* Gross income as defined in section 204 (b) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property,

and all other items constituting gross income under section 22. See section 22 (a), (b), and (c) and sections 28 and 334. It does not include increase in liabilities during the year on account of reinsurance treaties, remittances from 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 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. 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 § 29.201-4 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.

§ 29.204-3 *Deductions allowed insurance companies other than life or mutual marine insurance companies.* 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 other than life or marine, see section 207 (b) (4) (F) and the regulations thereunder. Insurance companies are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is the same as that allowed mutual insurance companies other than life or marine, see section 207 (b) (3) and the regulations thereunder.

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.

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). The graduated percentage reduction of gains and losses contained in section 117 (b) does not apply in the case of insurance companies but they are entitled to the alternative taxes provided in section 117 (c).

SEC. 205. 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 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 [as amended by sec. 205, Rev. Act 1939; sec. 165 (b), Rev. Act 1942.]

(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 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 a marine insurance company) 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) *Normal tax.* A normal tax on the normal-tax net income, computed at the rates provided in section 13 or section 14 (b), or 30 per centum of the amount by which the normal-tax net income exceeds $3,000, whichever is the lesser; plus

(B) *Surtax.* A surtax on the corporation surtax net income, computed at the rates provided in section 15 (b), or 20 per centum of the amount by which the corporation surtax net income exceeds $3,000, whichever is the lesser.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policy holders, 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) *Normal tax.* A normal tax on the normal-tax net income, computed at the rates provided in section 13 or section 14 (b), or 48 per centum of the amount by which the normal-tax net income exceeds $50,000, whichever is the lesser; plus

(B) *Surtax.* A surtax on the corporation surtax net income, computed at the rates provided in section 15 (b), or 32 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), 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) 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 other than life or marine, 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 other than life or marine. 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 corporations 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).

§ 29.207-1 *Tax on mutual insurance companies other than life or marine.* All mutual insurance companies other than life or marine (including foreign insurance companies carrying on an insurance business within the United States), 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 alternate 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.

The taxable income of mutual insurance companies other than life or marine 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 other than life or marine. See section 207 (d) and § 29.207-6.

All provisions of the Internal Revenue Code and of these regulations not inconsistent with the specific provisions of section 207 are applicable to the assessment and collection of the tax imposed by section 207 (a) and mutual insurance companies other than life or marine 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.

Foreign mutual insurance companies other than life or marine 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.

Mutual insurance companies other than life or marine, except inter-insurers 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, minus wholly tax-exempt interest of over $75,000, are subject to a tax computed under section 207 (a) (1) or section 207 (a) (2) whichever is the greater. The tax under section 207 (a) (1) is computed upon normal tax net income and corporation surtax net income at the rates provided in section 13 or section 14 (b) and in section 15 (b). The tax under section 207 (a) (2) is a tax equal to the excess of 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, over the amount of the tax imposed under subchapter E of chapter 2.

Under section 207 (a) (1), companies with normal-tax net incomes of between $3,000 and $6,153.86, and with corporation surtax net incomes of between $3,000 and $6,000, pay a normal tax, at the rate of 30 percent, and a surtax, at the rate of 20 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $3,000. Under section 207 (a) (2), companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, of between $75,000 and $150,000, pay a tax equal to the excess of 2 percent of that portion in excess of $75,000, over the amount of the tax imposed under subchapter E of chapter 2.

Interinsurers and reciprocal underwriters with corporation surtax net in-

comes of over $50,000 are taxed under section 207 (a) (3) upon normal-tax net income and corporation surtax net income at the rates provided in section 13 or section 14 (b) and in section 15 (b). Under section 207 (a) (3) interinsurers and reciprocal underwriters with normal-tax net incomes and corporation surtax net incomes of between $50,000 and $100,000 pay a normal tax, at the rate of 48 percent, and a surtax, at the rate of 32 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $50,000.

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.

The application of section 207 (a) (1), (2), (3), and (4) may be illustrated by the following examples:

Example (1). The X Company, a mutual casualty insurance company, for the taxable year 1942 has a corporation surtax net income of $3,500 and due to partially tax-exempt interest of $600, a normal-tax net income of $2,900. The gross amount of income of the X Company from interest, dividends, rents, net premiums, minus dividends to policyholders, minus wholly tax-exempt interest is $150,000. Its excess profits net income is $2,900. It is not subject to normal tax under section 207 (a) (1) for the taxable year 1942 as its normal-tax net income does not exceed $3,000. Its surtax is 20 percent of $500 ($3,500–$3,000) or $100, since that amount is less than $350, the surtax computed at the rate provided in section 15 (b). It has no normal tax and, therefore, its total tax under section 207 (a) (1) is the surtax of $100. Its excess profits net income is less than $5,000 and, therefore, there is no excess profits tax and the tax under section 207 (a) (2) is 1 percent of $150,000, 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, corporation surtax net income, and excess profits net income were each less than $2,900, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) was $90,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest was $70,000, the X 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 Y Company, a mutual fire insurance company, for the taxable year 1942 has a normal-tax net income of $6,000, a corporation surtax net income of $7,000, and an adjusted excess profits net income of $1,000. 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, minus 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 $3,000, or $900 (since this is less than $920, the tax computed at the rates provided in section 14 (b)); and the surtax would be 10 percent of $7,000, or $700 (since this is less than $800, the tax computed at 20 percent of the excess of the surtax net income over $3,000). The combined tax of $1,600 would then be reduced by applying section 207 (a) (4), since the gross receipts are between $75,000 and $125,000. The final tax under section 207 (a) (1) would be 90 percent of $1,600, or $1,440, since the $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000. The excess profits tax on the adjusted excess profits net income of $1,000 at the rate of 90 percent is $900 (this being less than the 80 percent limitation under section 710 (a) (1) (B)). Under the provisions of section 710 (a), after applying section 710 (a) (4), the excess profits tax is $810 (90 percent of $900) since $45,000 (the 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 (the 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 $450 is less than the amount of the excess profits tax of $810 there is no tax under section 207 (a) (2) and the tax under section 207 (a) (1) is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $1,440 and an excess profits tax of $810 or a total of $2,250.

Example (4). The Z Exchange, an inter-insurer, for the taxable year 1942 has a corporation surtax net income of $60,000 and, due to partially tax-exempt interest of $12,000, a 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 subject to normal tax under section 207 (a) (3) for the taxable year 1942 as its normal-tax net income is less than $50,000. Its surtax is 32 percent of $10,000 ($60,000—$50,000) or $3,200, since that amount is less than $9,000, the surtax computed at the rate provided in section 15 (b). Since it has no normal tax and is not subject to the tax imposed by section 207 (a) (2) nor entitled to the adjustment provided in section 207 (a) (4), its total tax under section 207 (a) is $3,200.

§ 29.207-2 *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).

§ 29.207-3 *Dividends to policyholders.* "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.

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 § 29.27 (b)-2 (a).

§ 29.207-4 *Net income and deductions*—(a) *In general.* The net income of a mutual insurance company other than life or marine 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 to the extent provided in section 117, 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. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company other than life or marine 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 other than life or marine 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 of a mutual insurance company other than life or marine 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 § 29.-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 § 29.201-7 (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 § 29.201-7 (e).)

(f) *Interest paid or accured.* 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 § 29.23 (b)-1.)

(g) *Capital losses.* 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 § 117 (d) (1).)

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 provision 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).

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, in the taxable year 1942 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, losses of $25,000, and 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 is 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 1942 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 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 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).

§ 29.207-5 *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 other than life or marine is the same as that provided in the case of life insurance companies by section 201 (d). (See § 29.201-8.)

§ 29.207-6 *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 other than life or marine. 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 the regulations thereunder, see § 29.201-9, except that in determining the premium and discount of a mutual insurance company other than life or marine the basis provided in section 113 shall be used in lieu of the acquisition value.

NONRESIDENT ALIEN INDIVIDUALS

SEC. 211. TAX ON NONRESIDENT ALIEN INDIVIDUALS [as amended by sec. 109 (b) (c), Rev. Act 1941; secs. 106 (a) (b) (c), 160 (d) (e), 167, Rev. Act 1942.]

(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 terminable 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. [For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 106 (a), Rev. Act 1942, set forth below.]

(B) *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 tax imposed by paragraph (1) shall not apply to any individual if the aggregate amount received during the taxable year from the sources therein specified is more than $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 who has a gross income for any taxable year of more than $15,400 from the sources specified in subsection (a) (1), shall be taxable without regard to the provisions of subsection (a) (1), except that—

(1) The gross income shall include only income from the sources specified in subsection (a) (1);

(2) The deductions (other than the so-called "charitable deduction" provided in section 213 (c)) shall be allowed only if and to the extent that they are properly allocable to the gross income from the sources specified in subsection (a) (1);

(3) The aggregate of the normal and surtax under sections 11 and 12 shall, in no case, be less than 30 per centum of the gross income from the sources specified in subsection (a) (1); and

(4) This subsection shall not apply to a resident of 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. [For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 106 (c), Rev. Act 1942, set forth below.]

SEC. 106. TAX ON NONRESIDENT ALIEN INDIVIDUALS. (Revenue Act of 1942, Title I.)

(a) *Tax in general.* Section 211 (a) (1) (A) (relating to tax on nonresident alien individuals not engaged in trade or business within the United States) is amended by striking out "27½ per centum" and inserting in lieu thereof "30 per centum". The amendments made by this subsection shall apply with respect to amounts received after the ninth day after the date of the enactment of this Act regardless of whether the taxable year of the recipient begins before January 1, 1942, or after December 31, 1941.

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(c) *Tax where gross income of more than $15,400.* Section 211 (c) (relating to tax on certain nonresident alien individuals) is amended by striking out "$23,000" wherever occurring therein and inserting in lieu thereof "$15,400"; and by striking out "27½" per centum" and inserting in lieu thereof "30 per centum". In the application of the amendments made by this subsection, the rate shall be 27½ per centum with respect to the period ending with the ninth day after the date of the enactment of this Act and shall be 30 per centum with respect to the period after such day.

SEC. 109. TREATY OBLIGATIONS. (Revenue Act of 1942, Title I.)

No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.

§ 29.211-1 *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 § 29.211-7.

§ 29.211-2 *Definition.* A "nonresident alien individual" means an individual:

(a) Whose residence is not within the United States; and

(b) Who is not a citizen of the United States.

The term includes a nonresident alien fiduciary.

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or 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.

§ 29.211-3 *Alien seamen, when to be regarded as residents.* In order to determine whether an alien seaman is a resident within the meaning of 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 § 29.211-4, 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.

§ 29.211-4 *Proof of residence of alien.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of chapter 1. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overcome:

(a) In the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (1) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (2) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (3) 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;

(b) In other cases by (1) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (2) proof that the alien has filed Form 1078 or its equivalent, or (3) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

In any case in which an alien seeks to overcome the presumption of nonresidence under paragraph (a) (3) or (b) (3), if the internal-revenue officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits.

§ 29.211-5 *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.

§ 29.211-6 *Duty of employer to determine status of alien employee.* If wages are paid to aliens without withholding the tax, except as permitted in § 29.143-3, 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 §§ 29.211-1 to 29.211-5, 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.

§ 29.211-7 *Taxation of nonresident alien individuals.* For the purposes of this section and §§ 29.212-1, 29.213-1, 29.214-1, 29.215-1, and 29.217-2, 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 the taxable year not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United State; (2) nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States; and (3) nonresident alien individuals who at any time during the taxable year are engaged in trade or business in the United States.

(a) *No United States business; general* rule. A nonresident alien individual within class (1), referred to in the preceding paragraph, is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 211 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the 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 § 29.143-2. The items of fixed or determinable annual or periodical income from sources within the United States received by a citizen of France residing in France which are exempt from Federal income taxation under the provisions of the tax convention between the United States and France, signed April 27, 1932, and effective January 1, 1936 (See Part 13 of this chapter), are described in § 29.143-3. As to items of such income received on or after January 1, 1940, by individual residents of Sweden or by Swedish corporations or other Swedish entities and exempt from Federal income taxation, see the tax convention between the United States and Sweden, effective January 1, 1940, and the regulations thereunder (see Part 25 of this chapter). Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) certain annuities and pensions received on and after January 1, 1941, by individual residents of Canada are exempt from tax.

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 on and after October 31, 1942 (27½ percent as to such income received before October 31, 1942), 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 percent) as may be provided by treaty with such country. (See also § 29.212-1.) Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) and effective January 1, 1941, the tax rates of 27½ percent or 30 percent, as the case may be, otherwise imposed by section 211 (a), were reduced to 15 percent as to items of income received on or after April 30, 1941, in the case of a nonresident alien individual who is a resident of Canada (see §§ 7.10 to 7.17, inclusive, of this chapter[1]).

(b) *No United States business; aggregate more than $15,400.* A nonresident alien individual within class (2), referred to in the first paragraph of this section, is under the provisions of section 211 (c), subject to tax only upon his fixed or determinable annual or periodical income specified in section 211 (a) determined under the provision of section 119, minus (1) the deductions properly allocable to such income and (2) the so-called "charitable contributions" deduction provided in section 213 (c). Such nonresident alien is entitled to the credits against net income allowable to an individual by section 25, subject to the limitations provided in section 214. However, the tax thus computed under sections 11 and 12 shall in no such case be less than 30 percent (27½ percent prior to October 31, 1942) of the gross amount of such fixed or determinable annual or periodical income from sources within the United States. Nonresident aliens within class (2) (other than residents of Canada) are also subject to the victory tax imposed by section 450. A nonresident alien, a resident of Canada, within class (2) is not subject to the provisions of section 211 (c) or of this section but is subject to taxation as set forth in paragraph (a) of this section regardless of the amount of his fixed or determinable annual or periodical income from sources within the United States (see §§ 7.10 to 7.17, inclusive, of this chapter[1]).

(c) *United States business.* A nonresident alien individual within class (3) referred to in the first paragraph of this section, is not taxable at the rate of 30 percent (27½ percent prior to October 31, 1942) upon the items of gross income enumerated in section 211 (a). The net income from sources within the United States of such a nonresident alien individual (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 213) less the credits against net income allowable to an individual by section 25, is subject to the normal tax of 6 percent imposed by section 11, the graduated surtax imposed by section 12 (b), and the victory tax imposed by section 450.

[1] 7 F.R. 4825.

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 § 29.212-1.) 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.

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.

SEC. 212. GROSS INCOME.

(a) *General rule.* In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

(b) *Ships under foreign flag.* The income of a nonresident alien individual which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States shall not be included in gross income and shall be exempt from taxation under this chapter.

§ 29.212-1 *Gross income of nonresident alien individuals.* In general, in the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 119. (See §§ 29.119-1 to 29.119-14, inclusive.) 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 §§ 29.211-2 to 29.211-6, inclusive.

Income received by a resident alien from sources without the United States is taxable although such person may be-

come a nonresident alien subsequent to its receipt and prior to the close of the taxable year. Conversely, income received by a nonresident alien from sources without the United States is not taxable though such person may become a resident alien subsequent to its receipt and prior to the close of the taxable year.

(a) *No United States business.* 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. His taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(b) *United States business.* 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).)

In general, any nonresident alien individual who performs personal services within the United States is considered as being engaged in trade or business within the United States and therefore his net income from sources within the United States, including his compensation, is subject to the normal tax of 6 percent, the surtax, and the victory tax. However, the phrase "engaged in trade or business within the United States" does not apply to the personal services performed within the United States for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such compensation is not income from sources within the United States. (See section 119 (a) (3).) As to the exclusion from gross income of the official compensation received by employees of foreign governments, see section 116 (h).

The effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian does not bring a nonresident alien individual within the class of nonresident alien individuals engaged in trade or business within the United States, but if a nonresident alien individual by reason of rendering personal services in the United States, or for other reasons, is classed as a nonresident alien individual engaged in trade or business within the United States, 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. 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.

§ 29.212-2 *Exclusion of earnings of foreign ships from gross income.* So much of the income from sources within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States 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 section.

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.

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.

§ 29.213-1 *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.

(2) *Aggregate more than $15,400.* A nonresident alien individual (other than a resident of Canada) 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 gross amount of fixed or determinable annual or periodical income from sources within the United States is allowed for such year only such deductions as are properly allocable to such income. He is also allowed the contributions or gifts made within the taxable year whether or not connected with income from sources within the United States but only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject to the limitations provided in section 23 (o).

(b) *United States business.* 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 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. (See also section 215.) In the case of such taxpayers, however, (1) losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, although not connected with the trade or business, are (if otherwise allowable) deductible only if and to the extent that the profit, if such transaction had resulted in a profit, would have been taxable as income from sources within the United States; (2) losses sustained during the taxable year of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise, are deductible only if the property

was located within the United States; and (3) contributions or gifts made within the taxable year are deductible, only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject to the limitation provided in section 23 (o).

Losses embraced under paragraph (a) (2) of this section 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 § 29.119-12. Losses embraced under paragraph (a) (1) are deductible in full (as provided in § 29.119-10 or § 29.119-11) when the profit from the transaction, if it had resulted in a profit, would have been taxable in full as income from sources within the United States, but should be deducted under the provisions of § 29.119-12 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

SEC. 214. CREDITS AGAINST NET INCOME [as amended by sec. 6 (b), Rev. Act 1940; sec. 111 (b), Rev. Act 1941; sec. 131 (a), Rev. Act 1942].

In the case of a nonresident alien individual the personal exemption allowed by section 25 (b) (1) of this chapter shall, except as hereinafter provided in the case of a resident of a contiguous country, be only $500. In the case of a nonresident alien individual residing in a contiguous country who is married and living with husband or wife or who is the head of a family, the personal exemption shall be that specified in section 25 (b) if such contiguous country allows to citizens of the United States not residing in such country who are married and living with husband or wife and to citizens of the United States not residing in such country who are heads of families the same personal exemption as that allowed citizens of such country who are married and living with husband or wife or who are heads of families, as the case may be. The credit for dependents allowed by section 25 (b) (2) shall not be allowed in the case of a nonresident alien individual unless he is a resident of a contiguous country.

§ 29.214-1 *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 (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year and deriving in such year gross amount of fixed or determinable annual or periodical income from sources within the United States or 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 who at any time within the taxable year was engaged in trade or business within the United States, the personal exemption allowed as a credit against net income by section 25 (b) (1) shall, except in the case of a resident of a contiguous country, be $500, whether such alien is a single person, a married person living with husband or wife, or the head of a family. However, in the case of a resident of Canada or Mexico the same personal exemption as in the case of a citizen of the United States applies on the basis of reciprocity. If, therefore, it is established to the satisfaction of the Commissioner that the individual is married and living with husband or wife or is the head of a family, as the case may be, the personal exemption pertaining to such status will be applicable, provided that the country of which the individual is a resident, allows a citizen of the United States not residing in such country, and who is married and living with husband or wife or is the head of a family, the same personal exemption as is allowed by such country to its own citizens who occupy such status. The credit for dependents provided by section 25 (b) (2) is allowed to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States only if they are residents of Canada or Mexico. If the status of the taxpayer as to dependents changes during the taxable year, the credit for dependents shall be determined as provided in § 29.25-7.

SEC. 215. ALLOWANCE OF DEDUCTIONS AND CREDITS.

(a) *Return to contain information.* A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this 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 personal exemption and credit for dependents may, in the discretion of the Commissioner and under regulations prescribed by him with the approval of the Secretary, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

§ 29.215-1 *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 or credits even though he may file a return of income.

(2) *Aggregate more than $15,400.* Unless a nonresident alien individual (other than a resident of Canada) 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, fixed or determinable annual or periodical income in a gross amount of more than $15,400 shall file or cause to be filed with the collector a true and accurate return of his total fixed or determinable annual or periodical income from sources within the United States as required by paragraph (a) (2) of § 29.217-2, the tax shall be collected on the basis of gross amount of such fixed or determinable annual or periodical income. Where such nonresident alien has various sources of fixed or determinable annual or periodical income from within the United States, as, for instance, from an estate or trust, from stocks or bonds held directly by him, or from securities held for him by a custodian resident in the United States, so that his total gross fixed or determinable annual or periodical income from United States sources is in excess of $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 fixed or determinable annual or periodical income from all sources within the United States concerning which he has information without allowance for deductions and credits, and will assess the tax and collect it from one or more of the sources of income within the United States. Such nonresident alien shall make or have made a full and accurate return on Form 1040NB-a of all his fixed or determinable annual or periodical income from sources within the United States. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (b) of § 29.217-2, which is hereby made equally applicable in the case of a nonresident alien individual coming within the provisions of this paragraph.

(b) *United States business.* 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 collector, a true and accurate return of his total income from sources within the United States, as required by paragraph (b) of § 29.217-2, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a nonresident alien has various sources of income within the United States, so that his total income calls for the assessment of a surtax, and a return of income was not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the income of such nonresident alien from all sources concerning which he has information, without allowance for deductions or credits, and will assess the tax and collect it from one or more of the sources of income of such nonresident alien within the United States.

SEC. 216. CREDITS AGAINST TAX [as amended by sec. 504, 2d Rev. Act. 1940].

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. 217. RETURNS [as amended by sec. 5 (e), Current Tax Payment Act 1943.]

(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. [NOTE.—The amendment of this provision by sec. 5 (a), Current Tax Payment Act 1943, is, under sec. 5 (f) thereof, effective with respect to taxable years beginning after December 31, 1942. Such amendment added the words "with respect to * * * made applicable".]

(b) *Exemption from requirement.* Subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Commissioner, with the approval of the Secretary, nonresident alien individuals subject to the tax imposed by section 211 (a) may be exempted from the requirement of filing returns of such tax.

§ 29.217-1 *Time and place for filing returns of nonresident alien individuals.* The return in the case of a nonresident alien individual must be made on or before the 15th day of the sixth month following the close of the fiscal year or on before the 15th day of June, if on the basis of the calendar year. For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter. The return must be filed with the collector of internal revenue for the district in which the nonresident alien individual has his principal place of business in the United States, or if he has no principal place of business in the United States, then with the collector of internal revenue at Baltimore, Md. For failure to make and file return within the time prescribed, see section 291. For cases in which no return is required, see paragraph (a) of § 29.217-2.

§ 29.217-2. *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 fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(2) *Aggregate more than $15,400.* A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year deriving in such year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States, shall make or have made a full and accurate return on Form 1040NB-a of all his fixed or determinable annual or periodical income from sources within the United States. Such return need not disclose profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (b) of this section, which is hereby made equally applicable in the case of a nonresident alien coming within the provisions of this paragraph.

(b) *United States business.* 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 $500 during the taxable year.

The responsible representative or agent within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States 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 appointed will determine how completely the agent is substituted for the principal for tax purposes. See § 29.51-2. Any person who collects interest or dividends on deposited securities of such a nonresident alien, executes ownership certificates in connection therewith and sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the nonresident alien. Where upon filing a return of income it appears that such a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. (See § 29.143-4.)

SEC. 218. PAYMENT OF TAX [as amended by sec. 5 (e), Current Tax Payment Act 1943].

(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. [NOTE: The amendment of this provision by sec. (5) (e), Current Tax Payment Act 1943, is under sec. 5 (f) thereof, effective with respect to taxable years beginning after December 31, 1942. Such amendment added the words "with respect to * * * made applicable".]

(b) *Withholding at source.* For withholding at source of tax on income of nonresident aliens, see section 143.

§ 29.218-1 *Date on which tax shall be paid by nonresident alien individual.* In the case of a nonresident alien individual the tax is to be paid on or before the 15th day of June following the close of the calendar year, or, where the return is made on the basis of a fiscal year, on or before the 15th day of the sixth month following the close of the fiscal year. As to payment of the tax in installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of the war, see Part 472 of this chapter.

SEC. 219. PARTNERSHIPS [as amended by sec. 109 (f), Rev. Act 1942].

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.

§ 29.219-1 *Partnerships.* Whether a nonresident alien individual who is a member of a partnership is taxable under the provisions of (A) section 211 (a) or 211 (c) or (B) section 211 (b) may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 211 (a) or 211 (c), as the case may be, depending on whether in the taxable year he derives fixed or determinable annual or periodical income from sources within the United States of more than $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 § 29.211-7.)

FOREIGN CORPORATIONS

SEC. 231. TAX ON FOREIGN CORPORATIONS [as amended by sec. 206, Rev. Act 1939; sec. 3 (c), Rev. Act 1940; secs. 104 (d), 106, 109 (a), Rev. Act 1941; secs. 107, 160 (d) (e), Rev. Act 1942.]

(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. [NOTE: For rate of 27½ percent prior to October 31, 1942, in lieu of 30 percent, see sec. 107, Rev. Act 1942, set forth below.]

(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 14 (c) (1) 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) *Ships under foreign flag.* The income of a foreign corporation, which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States, shall not be included in gross income and shall be exempt from taxation under this chapter.

SEC. 107. TAX ON FOREIGN CORPORATIONS. (Revenue Act of 1942, Title I.)

Section 231 (a) (relating to tax on nonresident foreign corporations) is amended by striking out "27½ per centum" and inserting in lieu thereof "30 per centum". The amendments made by this section shall apply with respect to amounts received after the ninth day after the date of the enactment of this Act regardless of whether the taxable year of the recipient begins before January 1, 1942, or after December 31, 1941.

SEC. 109. TREATY OBLIGATIONS. (Revenue Act of 1942, Title I.)

No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.

§ 29.231-1 *Taxation of foreign corporations.* For the purposes of this section and §§ 29.231-2, 29.232-1, 29.235-1, 29.235-2 and 29.236-1, 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 § 29.3797-8); 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 § 29.3797-8).

(a) *Nonresident foreign corporations.* A nonresident foreign corporation is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 231 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Internal Revenue Code as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the definition of fixed or determinable annual or periodical income, see § 29.143-2. The items of fixed or determinable annual or periodical income from sources within the United States received by a corporation organized under the laws of France, which are exempt from Federal income tax under the provisions of the convention and protocol between the United States and France, signed April 27, 1932, and effective January 1, 1936 (see Part 13 of this chapter), are described in § 29.143-3. As to items of such income received on or after January 1, 1940, by Swedish corporations and exempt from Federal income taxation, see the tax convention between the United States and Sweden, effective January 1, 1940, and regulations thereunder (see Part 25 of this chapter). Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942 (the tax rates of 27½ percent or 30 percent, as the case may be, otherwise imposed by section 231 (a) are reduced to 15 percent as to items of income in the case of such corporations organized under the laws of Canada.

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 (27½ percent as to such income received prior to October 31, 1942). In the case of dividends received by a nonresident foreign corporation organized under the laws of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, the rate shall be reduced to such rate (not less than 5 percent) as may be provided by treaty with such country.

(b) *Resident foreign corporations.* A resident foreign corporation is not taxable 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 14 (c) (1), liable to a tax of 24 percent of its normal-tax net income (regardless of the amount thereof), that is, its net income from sources within the United States (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 232) less the credits allowed against net income by section 26 (a) and (b). A resident foreign corporation is also liable to the corporation surtax at the following rates:

(1) Upon corporation surtax net incomes of $25,000 or less, 10 percent of the amount thereof.

(2) Upon corporation surtax net incomes over $25,000 but not over $50,000, $2,500, plus 22 percent of the amount of such income in excess of $25,000.

(3) Upon corporation surtax net incomes of more than $50,000, 16 percent of the entire amount thereof.

The corporation surtax net income of a resident foreign corporation is its net income from sources within the United States less the credit allowed by section 26 (b), which credit is limited in amount to 85 percent of its net income from sources within the United States.

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.

§ 29.231-2 *Gross income of foreign corporations.* In the case of a foreign corporation, including a life insurance company not carrying on an insurance business within the United States and holding no reserve funds upon business transacted within the United States (see section 201 (b) (3)), an insurance company other than life or mutual not carrying on an insurance business within the United States (see section 204 (a) (3)), and a mutual insurance company other than life not carrying on an insurance business within the United States (see section 207 (a)), the term "gross income" means gross income from sources within the United States as defined and described in section 119. (See §§ 29.119-1 to 29.119-14, 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 § 29.201 (b)-2. As to foreign corporations formed or availed of to avoid surtax, see § 29.102-4. As to personal holding companies organized under the laws of foreign countries, see § 29.505-1. As to foreign personal holding companies, see sections 331 to 340, inclusive, and §§ 29.331-1 to 29.339-3, inclusive.

(a) *Nonresident foreign corporations.* A nonresident foreign corporation is taxable under section 231 (a) only on fixed or determinable annual or periodical gross income received from sources within the United States. Its taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United

States of personal property or real property located therein.

(b) *Resident foreign corporations.* The gross income from sources within the United States of a resident foreign corporation is not limited to the items of fixed or determinable annual or periodical income referred to in section 231 (a), but includes every item of gross income which is treated as income from sources within the United States, except those items which are specifically exempt from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See section 22 (b), 119, and 231 (d).)

A foreign corporation which effects transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian is not merely by reason of such transactions considered as being engaged in trade or business within the United States which would cause it to be classed as a resident foreign corporation. However, a foreign corporation which at any time within the taxable year is otherwise engaged in trade or business in the United States, being a resident foreign corporation, is taxable upon all income derived from sources within the United States, including the profits realized from such transactions. A resident foreign corporation is also required to include in its gross income capital gains, gains from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein.

§ 29.231-3 *Exclusion of earnings of foreign ships from gross income.* A resident foreign corporation may exclude from gross income under section 231 (d) so much of its income from sources within the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of a foreign country, to the same extent as provided in § 29.212-2 with respect to nonresident alien individuals.

A nonresident foreign corporation is not required to include in gross income such income from sources within the United States as is derived from the operation of a ship or ships, whether or not the foreign country under the laws of which such ships are documented meets the equivalent exemption requirements of the statute.

SEC. 232. DEDUCTIONS.

(a) *In general.* In the case of a foreign corporation the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119, under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(b) *Charitable, and so forth, contributions.* The so-called "charitable contribution" deduction allowed by section 23 (q) shall be allowed whether or not connected with income from sources within the United States.

§ 29.232-1 *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 § 29.231-1.)

(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 § 29.201 (b)-2. As to foreign corporations formed or availed of to avoid surtax, see § 29.102-4. As to personal holding companies organized under the laws of foreign countries, see § 29.505-1. As to foreign personal holding companies, see sections 331 to 340, inclusive, and §§ 29.331-1 to 29.339-3, inclusive.

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.

§ 29.233-1 *Allowance of deductions and credits.* The benefit of the deductions and credits allowed a resident foreign corporation can be had only by filing or causing to be filed with the collector a true and accurate return of its total income received from sources within the United States. Only items of interest and dividends included in gross income may be credited under section 26 (a) and (b). Inasmuch as a nonresident foreign corporation is taxable under section 231 (a) only upon fixed or determinable annual or periodical gross income received from sources within the United States, such foreign corporation may not receive the benefit of the deductions and credits by filing a return of income.

SEC. 234. CREDITS AGAINST TAX [as amended by sec. 505, 2d Rev. Act 1940].

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 393 to be paid by the personal service corporation of which it is a shareholder with respect to its tax liability under Supplement S.

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.

§ 29.235-1 *Time and place for filing returns of foreign corporations*—(a) *Nonresident foreign corporations.* The return in the case of a nonresident foreign corporation must be made on or before the 15th day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of a calendar then on or before the 15th day of June. If a nonresident foreign corporation has an agent in the United States, the return shall be made by the agent. The return must be filed with the collector of internal revenue, Baltimore, Md. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed, see section 291. For cases in which no return is required, see § 29.235-2 (a). For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter.

(b) *Resident foreign corporations.* The return in the case of a resident foreign corporation, in lieu of the time prescribed in section 235, shall be made on or before the 15th day of the third month following the close of the fiscal year, or on or before the 15th day of March if on the basis of the calendar year. (See section 53 (a) (1).) If the return is for a fractional part of a year, it shall be filed at the time prescribed in § 29.53-1. The return must be filed with the collector of internal revenue for the district in which the resident foreign corporation has its principal place of business or principal office or agency in the United States. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed, see section 291. For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter.

§ 29.235-2 *Return of income*—(a) *Nonresident foreign corporations.* If the tax liability of a nonresident foreign corporation is fully satisfied at the source a return of income is not required. A nonresident foreign corporation shall make or have made a return on Form 1120NB with respect to that portion of its income received from sources within the United States consisting of interest on so-called tax-free covenant bonds on which a tax of only 2 percent was withheld at the source, and with respect to any other fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(b) *Resident foreign corporations.* If a foreign corporation at any time within the taxable year is a resident corporation it shall make a full and accurate return on Form 1120 of its income received from sources within the United States.

SEC. 236. PAYMENT OF TAX.

(a) *Time of payment.* In the case of a foreign corporation not having any office or place of business in the United States the total amount of tax imposed by this 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.

§ 29.236-1 *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 the 15th day of June following the close of the calendar year, or if the return should be made on the basis of a fiscal year, then on the 15th day of the sixth month following the close of the fiscal year. As to payment of the tax in installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of the war, see Part 472 of this chapter.

(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 15th day of March following the close of the calendar year, or if the return is made on the basis of a fiscal year, then on the 15th day of the third month following the close of the fiscal year. If the return is made for a fractional part of a year; the tax shall be paid at the time prescribed in § 29.56-1 (a). As to payment of the tax in installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of the war, see Part 472 of this chapter.

SEC. 237. FOREIGN INSURANCE COMPANIES.

For special provisions relating to foreign insurance companies, see Supplement G.

POSSESSIONS OF THE UNITED STATES

SEC. 251. INCOME FROM SOURCES WITHIN POSSESSIONS OF UNITED STATES [as amended by sec. 207, Rev. Act 1939; sec. 6 (c), Rev. Act 1940; secs. 104 (e), 111 (c), Rev. Act 1941; secs. 131 (a), 159 (d), 160 (d), Rev. Act 1942].

(a) *General rule.* In the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section), for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) *Amounts received in United States.* Notwithstanding the provisions of subsection (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) *Tax in case of corporation*—(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.

(d) *Definition.* As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

(e) *Deductions.* (1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by Supplement H in the case of a nonresident alien individual engaged in trade or business within the United States.

(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.

(f) *Credits against net income.* A citizen of the United States entitled to the benefits of this section shall be allowed a personal exemption of only $500 and shall not be allowed the credit for dependents provided in section 25 (b) (2).

(g) *Allowance of deductions and credits.* Citizens of the United States and domestic corporations entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this 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.

(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.

§ 29.251-1 *Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States.* In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States:

(a) 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

(b) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, although such citizen was actively engaged in the management of such corporation, does not represent income derived from the active conduct of a trade or business within the possession of the United States, either on the taxpayer's own account or as an employee or agent of another.

A citizen of the United States who on account of the nature and amount of his income cannot meet the 80 percent and the 50 percent requirements of the 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, with respect to taxable years beginning prior to January 1, 1943, away from the United States for more than six months of the taxable year, or is, with respect to taxable years beginning after December 31, 1942, 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 25 (a) (4).

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.

For a determination of the income from sources within the United States, see section 119. A citizen entitled to the benefits of section 251 is required to file with his individual return Form 1040 or 1040A, 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.

Example. On July 1, 1942, A, who is a citizen of the United States, went to Puerto Rico and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1942 of some

Puerto Rican real estate not connected with his trade or business. In the first six months of 1942 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 1942. Inasmuch as for the applicable part (July 1, 1942, to December 31, 1942) of the 3-year period immediately preceding the close of the taxable year (the calendar year 1942), 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 1942 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States.)

§ 29.251-2 *Income received within the United States.* Notwithstanding the provisions of section 251 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example given in § 29.251-1, the taxpayer during the latter part of 1942 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the Puerto Rican real estate, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 251 with respect to other items of gross income excluded by that section.

§ 29.251-3 *Tax in case of corporations.* A domestic corporation entitled to the benefits of section 251 is, under section 251 (c) (1), subject to the tax imposed by section 13 if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b) if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a corporation is also subject to the surtax imposed by section 15 (see § 29.15-1).

§ 29.251-4 *Definition.* The term "United States" as used herein includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia. The term "possession of the United States," as used in sections 251 and 252 and § 29.251-1, this section, and § 29.252-1, includes Puerto Rico, the Philippine Islands, the Panama Canal Zone, Guam, American Samoa, Wake, and the Midway Islands; it does not include the Virgin Islands. The Philippine Islands come within the classification of "possessions of the United States" for Federal income tax purposes, notwithstanding the establishment of the Commonwealth of the Philippines under the Act of March 24, 1934 (48 Stat. 456).

§ 29.251-5 *Deductions allowed citizens and domestic corporations entitled to the benefits of section 251.* In the case of a citizen entitled to the benefits of section 251, the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of § 29.213-1 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 § 29.213-1 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 appportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119.

§ 29.251-6 *Allowance of deductions and credits to citizens and domestic corporations entitled to the benefits of section 251.* Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 251 shall file or cause to be filed with the collector a true and accurate return of total income from sources within the United States, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a citizen or corporation has various sources of income within the United States so that the total income calls for the assessment of a tax, and a return of income was not filed by or on behalf of the 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.

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.

(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.

§ 29.252-1 *Status of citizens of United States possession.* A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. (See sections 211 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.)

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: (1) citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States and (2) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States. The provisions of §§ 29.211-7 to 29.219-1, 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.

The Act referred to in section 252 (b) provides that income tax laws then or thereafter in force in the United States shall apply to the Virgin Islands, but that the taxes shall be paid into the treasury of the Virgin Islands. Accordingly, persons are taxed there under the income tax provisions of the Internal Revenue Code.

CHINA TRADE ACT CORPORATIONS

SEC. 261. TAXATION IN GENERAL [as amended by sec. 203, Rev. Act 1939; sec. 104 (f) (1), Rev. Act 1941].

(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.

§ 29.261-1 *Tax on China Trade Act corporations.* A China Trade Act cor-

poration is, under section 261 (a), subject to the tax imposed by section 13 (b) if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b) if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a corporation is also subject to the surtax imposed by section 15 (see § 29.15-1).

SEC. 262. CREDIT AGAINST NET INCOME [as amended by sec. 210 (c), Rev. Act 1939; sec. 104 (f) (2), Rev. Act. 1941.]

(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 method so provided.

(c) *Ownership of stock.* For the purposes of this section shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) *Definition of China.* As used in this section the term "China" shall have the same meaning as when used in the China Trade Act, 1922.

§ 29.262-1 *Income of China Trade Act corporations.* The items of gross income to be included in the return of a corporation organized under the China Trade Act and the deductions allowable are the same as in the case of other domestic corporations.

§ 29.262-2 *Credits allowed China Trade Act corporations.* In addition to the credits allowed under section 26 (a) and (b), a China Trade Act corporation is, under certain conditions, allowed an additional credit for the purpose of computing the taxes imposed by section 13 or 14, by section 15, and by section 600. This credit is an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 119) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease in the tax imposed by section 13 or 14, and section 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. The decrease in the tax imposed by section 600 by reason of such credit must not exceed the amount by which such special dividend exceeds the decrease permitted by section 262 in the tax imposed by section 13 or 14, and section 15. A China Trade Act corporation is not entitled to the credit for taxes paid to foreign countries and possessions of the United States allowed to domestic corporations under the provisions of section 131.

The application of this section may be illustrated by the following example:

Example. The A Company, a China Trade Act corporation, has a net income for the calendar year 1942 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1942, is owned on that date by persons resident in China, he United States, or possessions of the United States, or individual citizens of the United States or China. The declared value of the capital stock of the corporation shown on its capital stock tax return for the capital stock tax year ended June 30, 1942, is $1,500,000. It distributes a special dividend amounting to $85,000 on February 15, 1943, which is certified by the Secretary of Commerce as provided in section 262 (b).

For the purpose of the tax imposed by section 13, it is necessary in this example to make two computations, first, without allowing the special credit against net income on account of income derived from sources within China, and, second, allowing such credit. The computations are as follows:

FIRST COMPUTATION—WITHOUT ALLOWING THE SPECIAL CREDIT AGAINST NET INCOME

Net income subject to tax	$200,000
Normal-tax net income	200,000
Normal tax (section 13)	48,000
Surtax net income	200,000
Surtax (section 15)	32,000
Total income tax	80,000

SECOND COMPUTATION—ALLOWING SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible as a special credit against net income.	
Special credit against net income	200,000
Amount of income subject to tax under section 13	None

Since the special dividend ($85,000) exceeds the diminution of the tax ($80,000) on account of the allowance of the special credit against net income, the entire amount of the special credit is allowable and the corporation has no income tax liability for 1942.

For the purpose of the declared value excess-profits tax it is also necessary to make two computations, first, without allowing the special credit against net income, and, second, allowing such credit. The computations are as follows:

FIRST COMPUTATION—WITHOUT ALLOWING THE SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Less: 10 percent of the value declared in the capital stock tax return for the capital stock tax year ended June 30, 1942 (10 percent of $1,500,000)	150,000
Net income subject to declared value excess-profits tax	50,000
Less: Amount taxable at 6⁶⁄₁₀ percent, portion of net income in excess of 10 percent and not in excess of 15 percent of the declared value of the capital stock ($200,000 minus $150,000)	50,000
Amount taxable at 13²⁄₁₀ percent	None
Declared value excess-profits tax at 6⁶⁄₁₀ percent (6⁶⁄₁₀ percent of $50,000)	3,300

SECOND COMPUTATION—ALLOWING SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible from net income	200,000
Amount of income subject to declared value excess-profits tax	None

Since the diminution of the declared value excess-profits tax ($3,300) on account of the special credit against net income does not exceed the amount by which the special dividend ($85,000) exceeds the diminution of the income tax ($80,000) on account of such credit, the entire amount of the special credit ($200,000) is allowable and the corporation has no declared value excess-profits tax liability for 1942.

§ 29.262-3 *Meaning of terms used in connection with China Trade Act corporations.* A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922.

The term "China" means (1) China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, (2) the Crown Colony of Hong Kong, and (3) the Province of Macao.

The term "special dividend" means the amount which during the year ending on March 15 succeeding the close of the corporation's taxable year is distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

For the purposes of section 262 the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

"Net income derived from sources within China" is the sum of the net income from sources wholly within China and that portion of the net income from sources partly within and partly without China which may be allocated to sources within China. The method of computing this income is similar to that described in section 119.

§ 29.262-4 *Withholding by a China Trade Act corporation.* Dividends distributed by a corporation organized under the China Trade Act, 1922, which are treated as income from sources within the United States under the provisions of section 119 of the Internal Revenue Code are subject to withholding at the rate of 30 percent (27½ percent prior to October 31, 1942) 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 (27½ percent prior to October 31, 1942) rate of withholding specified in this section with respect to dividends shall be reduced in the case of shareholders who are (1) nonresident aliens residents of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, or (2) nonresident foreign corporations organized under the laws of any such country, to such rate (not less than 5 percent) as may be provided by treaty with such country. As to reduction in rate of withholding (i) in the case of nonresident alien individuals who are residents of Canada or Sweden, see § 29.143-1; (ii) in the case of corporations or other entities created or organized under the laws of Canada or Sweden, see § 29.144-1.

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. [Not applicable to taxable years beginning after December 31, 1941.]

SEC. 265. INCOME OF SHAREHOLDERS.

For exclusion of dividends from gross income, see section 116.

ASSESSMENT AND COLLECTION OF DEFICIENCIES

SEC. 271. DEFINITION OF DEFICIENCY.

As used in this chapter in respect of a tax imposed by this chapter "deficiency" means—

(a) The amount by which the tax imposed by this chapter exceeds the amount shown as the tax by the taxpayer upon his return; but the amount so shown on the return shall first be increased by the amounts previously assessed (or collected without assessment) as a deficiency, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or

(b) If no amount is shown as the tax by the taxpayer upon his return, or if no return is made by the taxpayer, then the amount by which the tax exceeds the amounts previously assessed (or collected without assessment) as a deficiency; but such amounts previously assessed, or collected without assessment, shall first be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect to such tax.

§ 29.271-1 *Deficiency defined.* Section 271 by its definition of the word "deficiency" provides a term which will apply to any amount of tax determined to be due in respect of a taxable year in excess of the amount of tax reported by the taxpayer for such year; or in excess of the amount reported by the taxpayer as adjusted by way of prior assessments, abatements, credits, refunds, or collections without assessment. In defining the term "deficiency" section 271 recognizes two classes of cases—one, where the taxpayer makes a return showing some tax liability; the other, where the taxpayer makes a return showing no tax liability, or where the taxpayer fails to make a return. Additional tax shown on an "amended return," so called, is a deficiency within the meaning of the Internal Revenue Code.

When a case is considered for the first time, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount shown as the tax by the taxpayer on his return, or, if it is a case where no tax was reported by the taxpayer, the deficiency is the amount determined to be the correct amount of the tax. Subsequent information sometimes discloses that the amount previously determined to be the correct amount of the tax is less than the correct amount, and that a redetermination of the tax is necessary. In such a case the deficiency on redetermination is the excess of the amount determined to be the correct amount of the tax over the sum of the amount of tax reported by the taxpayer and the deficiency assessed in connection with the previous determination. If it is a case where no tax was reported by the taxpayer, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount of the deficiency disclosed by the previous determination. If the previous determination resulted in a credit or refund to the taxpayer, the deficiency upon the second determination is the excess of the amount determined to be the correct amount of the tax over the amount of tax reported by the taxpayer decreased by the amount of the credit or refund.

SEC. 272. PROCEDURE IN GENERAL [as amended by sec. 163 (a), Rev. Act. 1942].

(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 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 [known as The Tax Court of the United States] 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.

§ 29.272-1 *Assessment of a deficiency.* 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, D. C., for the attention of the Income Tax Unit, Records Division. Within 90 days after notice of the deficiency is mailed (or within 150 days after mailing in the case of such a notice mailed after October 21, 1942, and 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, Sunday or a legal holiday in the District of Columbia is not to be counted as the ninetieth or one hundred fiftieth day. Except as stated in paragraphs (a), (b), (c), (d), and (e) 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.

(a) 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).

(b) 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 § 29.273-1.)

(c) 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 §§ 29.274-1 and 29.274-2.)

(d) (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 circuit court of appeals (or the United States Court of Appeals for the District of Columbia), the filing of the petition will not operate as a stay of the assessment of any portion of the deficiency determined by The 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.

(e) 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.

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.

§ 29.272-2 *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 amount so assessed shall be paid upon notice and demand from the collector. As to cases coming within the provisions of paragraphs (b), (c), and (d) of § 29.272-1, see sections 273 (i) and 298 and section 1145. As to interest on deficiencies, see section 292.

§ 29.272-3 *Extension of time for payment of a deficiency.* If it is shown to the satisfaction of the Commissioner that the payment of a deficiency upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner may grant an extension of time for the payment of the deficiency or any part thereof for a period not in excess of 18 months, and in exceptional cases for a further period not in excess of 12 months. The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the deficiency at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. The Internal Revenue Code provides that no extension will be granted where the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade tax.

An application for an extension of time for the payment of a deficiency should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the month in which falls the date prescribed for the payment of the deficiency are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a deficiency unless request therefor is made to the collector on or before the date prescribed for payment thereof, as shown by the notice and demand from the collector, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1127B in an amount not exceeding double the amount of the deficiency or to furnish other security satisfactory to the Commissioner for the payment of the liability on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the deficiency, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States as provided in section 1126 of the Revenue Act of 1926. The amount of the deficiency and additions thereto shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand from the collector. Payment of the deficiency and additions thereto before the expiration of the extension will not relieve the taxpayer from paying the entire amount of interest provided for in the extension. (See section 296.)

SEC. 273. JEOPARDY ASSESSMENTS.

(a) *Authority for making.* If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he shall immediately assess such deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) and notice and demand shall be made by the collector for the payment thereof.

(b) *Deficiency letters.* If the jeopardy assessment is made before any notice in respect of the tax to which the jeopardy assessment relates has been mailed under section 272 (a), then the Commissioner shall mail a notice under such subsection within sixty days after the making of the assessment.

(c) *Amount assessable before decision of Board.* The jeopardy assessment may be made in respect of a deficiency greater or less than that notice of which has been mailed to the taxpayer, despite the provisions of section 272 (f) prohibiting the determination of additional deficiencies, and whether or not the taxpayer has theretofore filed a petition with the Board of Tax Appeals [known as The Tax Court of the United States]. 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 remain-

ing 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.

§ 29.273-1 *Jeopardy assessments.* If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he is required to assess such deficiency immediately, together with the interest and other additional amounts provided by law. If a deficiency is assessed on account of jeopardy after the decision of The 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.

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 mailed after October 21, 1942, and addressed to a person outside the States of the Union and the District of Columbia), not counting Sunday or a legal holiday in the District of Columbia as the ninetieth or one hundred fiftieth 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).)

After a jeopardy assessment has been made, the list showing such assessment will be immediately transmitted to the collector. Upon receipt of the list containing the assessment, the collector is required to send notice and demand to the taxpayer for the amount of the jeopardy assessment. Regardless of whether the taxpayer has filed a petition with The 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 collector, unless before the expiration of such 10-day period he files with the collector a bond on Form 1429 of the character hereinafter prescribed. The bond must be in such amount, not exceeding double the amount for which the stay is desired, as the collector deems necessary and must be executed by sureties satisfactory to the collector. It must be conditioned upon the payment of so much of the amount included therein as is not abated by a decision of The 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 collector will be so advised, and, if collection of the deficiency has been stayed by the filing of a bond within 10 days after the date of jeopardy notice and demand, he should then give notice and make demand for payment of the amount assessed plus interest. Any bond filed after the expiration of 10 days from the date of the jeopardy notice and demand is not such a bond as is contemplated by section 273 (f), and, while the collector may in his discretion accept the bond and stay collection of the deficiency, the taxpayer will not be relieved from payment of interest on the amount of the deficiency at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of payment.

Upon the filing of a bond of the character described within 10 days after the date of notice and demand for payment of the amount assessed, the collection of so much thereof as is covered by the bond will be stayed. The taxpayer may at any time waive the stay of collection of the whole or any part of the amount covered by the bond. If as a result of such waiver any part of the amount covered by the bond is paid, or if any portion of the jeopardy assessment is abated by the Commissioner before the decision of The 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.

After The Tax Court has rendered its decision and such decision has become final, the collector will be notified of the action taken. The collector will then send notice and demand for the unpaid portion of the amount determined by The Tax Court, the collection of which has been stayed by the bond. The collector is required to include in the notice and demand for the unpaid portion, interest at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of the notice and demand referred to in this paragraph. If the amount of the jeopardy assessment is less than the amount determined by The 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 collector. 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.

As to bankruptcy, proceedings for the relief of debtors and receivership cases, see sections 274 and 298 and §§ 29.274-1 and 29.274-2.

SEC. 274. BANKRUPTCY AND RECEIVERSHIPS. (a) *Immediate assessment.* Upon the adjudication of bankruptcy of any taxpayer in any bankruptcy proceeding or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) determined by the Commissioner in respect of a tax imposed by this 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 [known as The Tax Court of the United States]; 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.

§ 29.274-1 *Bankruptcy and receivership proceedings.* During a bankruptcy proceeding, or an equity receivership proceeding in either a Federal or a State court, the assets of the taxpayer are in general under the control of the court in which such proceeding is pending, and the collection of taxes cannot be made by distraining upon such assets. However, any assets which under applicable provisions of law are not under the control of the court may be subject to distraint.

As used in these regulations the term "bankruptcy proceeding" includes proceedings under Chapters I to VII of the Bankruptcy Act, as amended, or under section 74, 75, 77, or 77B, or Chapters X to XIII, or Chapter XV, of such Act, as amended; and the term "adjudication of bankruptcy" includes, in addition to an adjudication in a proceeding under Chapters I to VII, the approval of a petition as properly filed under section 77 or 77B or Chapter X by a court of competent jurisdiction or the filing of a petition under section 74 or 75 or Chapters XI to XIII or Chapter XV with a court of competent jurisdiction.

A trustee in bankruptcy (including a trustee, receiver, debtor in possession, or other person designated as in control of the assets of a debtor in any bankruptcy proceeding by order of the court in which such proceeding is pending) or a receiver in any receivership proceeding is required to give notice in writing to the Commissioner of Internal Revenue in Washington, D. C., of the adjudication of bankruptcy or the appointment of a receiver. (See section 274 (a) and § 29.275-1.)

Collectors 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, as amended, and the orders of the court in which such proceeding is pending, file claim covering such liability in the court in which such proceeding is pending. Such claim should be filed whether the unpaid taxes involved have been assessed or not, except in cases where the departmental instructions direct otherwise; for example, where the payment of the taxes is secured by a sufficient bond. Such claims should cover the amount represented by the assessment, plus interest at the rate of 6 percent per annum for the period from the date of filing claim by the collector to the date of termination of the bankruptcy or receivership proceeding or to the date of payment if payment is made in full prior to such termination. At the same time claim is filed with the bankruptcy or receivership court, the collector will send notice and demand for payment to the taxpayer together with a copy of such claim.

Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended, and section 64 of the Bankruptcy Act, as amended, taxes are entitled to the priority over other claims therein stated and the trustee, receiver, debtor in possession, or other person designated as in control of the assets of the debtor by the court in which bankruptcy or receivership proceeding is pending, may be held personally liable for failure on his part to protect the priority of the Government respecting taxes of which he has notice. Bankruptcy courts have jurisdiction under the Bankruptcy Act, as amended, to determine all disputes regarding the amount and validity of taxes of a bankrupt or of a debtor in a proceeding under the Bankruptcy Act, as amended. A bankruptcy or receivership proceeding does not discharge any portion of a claim of the United States for taxes except in the case of a proceeding under Chapter X of the Bankruptcy Act, as amended, and except to the extent which may be provided in a plan or arrangement duly effectuated in a bankruptcy proceeding; and any portion of a claim of the United States for taxes which has been allowed by the court in which the bankruptcy or receivership proceeding is pending and which remains unsatisfied after the termination of the bankruptcy or receivership proceeding shall be collected with interest as provided in section 298.

§ 29.274-2 *Immediate assessments in bankruptcy and receivership cases.* If the Commissioner has determined that a deficiency is due in respect of income tax and the taxpayer has filed a petition with The 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 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.

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, debtor, 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.

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 repect to such deficiency. If after such evidence is submitted and hearing held any adjustment appears necessary in the deficiency, appropriate action will be taken. A copy of the notification letter will be attached to the assessment list as the collector's authority for filing claim in any bankruptcy or receivership proceeding.

If any portion of the claim allowed by the court in a bankruptcy or receivership proceeding remains unpaid after the termination of such proceeding, the collector will send notice and demand for payment thereof to the taxpayer. Such unpaid portion with interest as provided in section 298 may be collected from the taxpayer by distraint or proceeding in court within six years after the termination of the bankruptcy or receivership proceeding. Extensions of time for the payment of such unpaid amount may be granted in the same manner and subject to the same provisions and limitations as provided in sections 272 (j) and 297. (See § 29.272-3.)

This section deals only with immediate assessments provided for in section 274 and the procedure in connection with such assessments.

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION [as amended by sec. 503, 2d Rev. Act 1940].

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. 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.

SEC. 277. SUSPENSION OR 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 [known as The Tax Court of the United States], until the decision of the Board becomes final), and for sixty days thereafter.

§ 29.275-1 *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 paragraph (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 §§ 29.274-1 and 29.274-2.

With respect to the period of limitation for assessing the amount of the liability of a transferee of property, or for assessing the amount of the liability of a fidu-

ciary under section 3467 of the Revised Statutes, as amended, see section 311.

§ 29.275-2 *Period of limitation upon collection of tax.* 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.

The exceptions to the period of limitation upon collection of the tax without assessment stated in the preceding paragraph 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, 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 paragraph (a) (1), (a) (2), and (a) (3) of § 29.275-1 also must be met.

(b) A proceeding in court for the collection of the tax without assessment may be begun at any time:

(1) In case the taxpayer files a false or fraudulent return with intent to evade tax; or

(2) In case the taxpayer fails to file a return.

(c) 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.

(d) 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.

(e) If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an amount distributed in liquidation of a corporation, other than a foreign personal holding company, a proceeding in court for the collection of the tax may be begun without assessment at any time within four years after the return was filed.

In any case in which the tax has been assessed within the statutory period of limitation properly applicable thereto, a proceeding in court or distraint for the collection of such tax may be begun within six years after the assessment thereof, or prior to the expiration of any period for collection agreed upon in writing by the Commissioner and the taxpayer before the expiration of such 6-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. In determining the running of the statute of limitations in respect of distraint, the distraint shall be held to have been begun, in the case of personal property, on the date on which the levy upon such property is made, or, in the case of real property, on the date on which notice of the time and place of sale is given to the person whose estate it is proposed to sell.

If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a) (see § 29.272-1), 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.

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 § 29.274-2.

INTEREST AND ADDITIONS TO THE TAX

SEC. 291. FAILURE TO FILE RETURN [as amended by sec. 172 (f), Rev. Act 1942].

(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 amounts 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).

(b) For minimum addition to the tax for failure of withholding agent to make and file return required by Part II of Subchapter D,[1] see section 470 (c).

§ 29.291-1 *Addition to the tax in case of failure to file return.* In case of failure to make and file a return required by 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.

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 an affidavit which should be filed with the collector, who, unless otherwise directed by the Commissioner, will forward the affidavit 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.

If the addition to the tax for delinquency in filing the return has been added, the amount so added shall be collected in the same manner as the tax.

For addition to the tax in case of a deficiency due to fraud with intent to evade tax, see section 293. As to the making of returns for taxpayers by collectors or the Commissioner in the case of delinquency in filing a return, or in the case of a false or fraudulent return, see section 3612.

SEC. 292. INTEREST ON DEFICIENCIES.

Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax, at the rate of 6 per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed, or, in the case of a waiver under section 272 (d), to the thirtieth day after the filing of such waiver or to the date the deficiency is assessed whichever is the earlier.

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

(a) *Negligence.* If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272 (i), relating to the prorating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable.

(b) *Fraud.* If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (2).

SEC. 294. ADDITIONS TO THE TAX IN CASE OF NONPAYMENT [as amended by sec. 5 (b), Current Tax Payment Act 1943.]

[1] Subchapter D of chapter 1.

(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.

(3) *Failure to file declaration of estimated tax.* In the case of a failure to make and file a declaration of estimated tax within the time prescribed, there shall be added to the tax an amount equal to 10 per centum of the tax. [NOTE.—Under sec. 5 (f), Current Tax Payment Act 1943, this provision is effective with respect to taxable years beginning after December 31, 1942.]

(4) *Failure to pay installment of estimated tax.* In the case of the failure to pay an installment of the estimated tax within the time prescribed, there shall be added to the tax $2.50 or 2½ per centum of the tax, whichever is the greater, for each installment with respect to which such failure occurs. [NOTE: Under sec. 5 (f), Current Tax Payment Act 1943, this provision is effective with respect to taxable years beginning after December 31, 1942.]

(5) *Substantial underestimate of estimated tax.* If 80 per centum of the tax (determined without regard to the credits under sections 32, 35, and 466 (e)), 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. [NOTE: Under sec. 5 (f), Current Tax Payment Act 1943, this provision is effective with respect to taxable years beginning after December 31, 1942, but is not applicable to a taxable year beginning in 1943 in the case of an individual not required to make a declaration under section 58, Internal Revenue Code, for such year.]

(b) *Deficiency.* Where a deficiency, or any interest or additional amounts assessed in connection therewith under section 292, or under section 293, or any addition to the tax in case of delinquency provided for in section 291, is not paid in full within ten days from the date of notice and demand from the collector, there shall be collected as part of the tax, interest upon the unpaid amount at the rate of 6 per centum per annum from the date of such notice and demand until it is paid. If any part of a deficiency prorated to any unpaid installment under section 272 (i) is not paid in full on or before the date prescribed for the payment of such installment, there shall be collected as part of the tax interest upon the unpaid amount at the rate of 6 per centum per annum from such date until it is paid.

(c) *Filing of jeopardy bond.* If a bond is filed, as provided in section 273, the provisions of subsection (b) of this section shall not apply to the amount covered by the bond.

SEC. 295. TIME EXTENDED FOR PAYMENT OF TAX SHOWN ON RETURN.

If the time for payment of the amount determined as the tax by the taxpayer, or any installment thereof, is extended under the authority of section 56 (c), there shall be collected as a part of such amount, interest thereon at the rate of 6 per centum per annum from the date when such payment should have been made if no extension had been granted, until the expiration of the period of the extension.

SEC. 296. TIME EXTENDED FOR PAYMENT OF DEFICIENCY.

If the time for the payment of any part of a deficiency is extended, there shall be collected, as a part of the tax, interest on the part of the deficiency the time for payment of which is so extended, at the rate of 6 per centum per annum for the period of the extension, and no other interest shall be collected on such part of the deficiency for such period. If the part of the deficiency the time for payment of which is so extended is not paid in accordance with the terms of the extension, there shall be collected, as a part of the tax, interest on such unpaid amount at the rate of 6 per centum per annum for the period from the time fixed by the terms of the extension for its payment until it is paid, and no other interest shall be collected on such unpaid amount for such period.

SEC. 297. INTEREST IN CASE OF JEOPARDY ASSESSMENTS.

In the case of the amount collected under section 273 (i) there shall be collected at the same time as such amount, and as a part of the tax, interest at the rate of 6 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 concealing property in such manner as to hinder collection of the tax, see section 146.

CLAIMS AGAINST TRANSFEREES AND FIDUCIARIES

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of collection.* The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this 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, § 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 [known as The Tax Court of the United States], 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.

§ 29.311-1 *Claims in cases of transferred assets.* The amount for which a transferee of the property of a taxpayer is liable, at law or in equity, and the amount of the personal liability of a fiduciary under section 3467 of the Revised Statutes, as amended, in respect of any income tax imposed by 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 the tax imposed by chapter 1.

The term "transferee" as used in this section includes an heir, legatee, devisee, distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in section 112, and all other classes of distributees.

The period of limitation for assessment of the liability of a transferee or of a fiduciary, referred to in the first paragraph of this section, is as follows:

(a) 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);

(b) In the case of the liability of a transferee or 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;

(c) If a court proceeding against the taxpayer or last preceding transferee for the collection of the tax or liability in respect thereof, respectively, has been begun within the period of limitation for the bringing of such proceeding, then within one year after the return of execution in such proceeding; and

(d) 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.

(e) If before the expiration of the time prescribed in section 311 (b) (1), (2), or (3) for the assessment of the liability of a transferee or fiduciary, both the Commissioner and the transferee or fiduciary have consented in writing to the assessment of the liability after such time, the liability may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

For the purpose of determining the period of limitation for assessment against a transferee or a fiduciary, if the taxpayer is deceased, or, in the case of a corporation, has terminated its existence, the period of limitation for assessment against the taxpayer shall be the period that would be in effect had the death or termination of existence not occurred.

If a notice of the liability of a transferee or the liability of a fiduciary has been mailed to such transferee or to such fiduciary under the provisions of section 272 (a), then the running of the statute of limitations shall be suspended for the period during which the Commissioner is prohibited from making the assessment in respect of the liability of the transferee or fiduciary (and in any event, if a proceeding in respect of the liability is placed on the docket of The Tax Court, until the decision of The Tax Court becomes final), and for 60 days thereafter.

SEC. 312. NOTICE OF FIDUCIARY RELATIONSHIP. (a) *Fiduciary of taxpayer.* Upon notice to the Commissioner that any person is acting in a fiduciary capacity such fiduciary shall assume the powers, rights, duties, and privileges of the taxpayer in respect of a tax imposed by this 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 privileges of such person under such section (except that the liability shall be collected from the estate of such person), until notice is given that the fiduciary capacity has terminated.

(c) *Manner of notice.* Notice under subsection (a) or (b) shall be given in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

§ 29.312-1 *Fiduciaries.* As soon as the Commissioner receives notice that a person is acting in a fiduciary capacity, such fiduciary must, except as otherwise specifically provided, assume the powers, rights, duties, and privileges of the taxpayer with respect to income tax imposed by 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, in respect of the payment of any tax from the estate of the taxpayer. Any such written notice which has been filed with the Commissioner since the enactment of the Revenue Act of 1926 shall be considered as sufficient notice to the Commissioner within the meaning of section 312. Unless there is already on file with the Commissioner satisfactory evidence of the authority of the fiduciary to act for such person in a fiduciary capacity, such evidence must be filed with and made a part of the notice. If the fiduciary capacity exists by order of court, a certified copy of the order may be regarded as such satisfactory evidence. When the fiduciary capacity has terminated, the fiduciary in order to be relieved of any further duty or liability as such, must file with the Commissioner written notice that the fiduciary capacity has terminated as to him, accompanied by satisfactory evidence of the termination of the fiduciary capacity. The notice of termination should state the name and address of the person, if any, who has been substituted as fiduciary.

If the notice of the fiduciary capacity described in the preceding paragraph is not filed with the Commissioner prior to the sending of notice of a deficiency by registered mail to the last known address of the taxpayer (see section 272 (a)), or the last known address of the transferee or other person subject to liability (see section 311), no notice of the deficiency will be sent to the fiduciary. In such a case the sending of the notice to the last known address of the taxpayer, transferee, or other person, as the case may be, will be a sufficient compliance with the requirements of the 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 mailed after October 21, 1942, and 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 collector. 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.

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.

SEC. 313. CROSS REFERENCE.

For prohibition of suits to restrain enforcement of liability of transferee or fiduciary, see section 3653 (b).

OVERPAYMENTS

SEC. 321. OVERPAYMENT OF INSTALLMENT.

If the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any. If the amount already paid, whether or not on the basis of installments, exceeds the amount determined to be the correct amount of the tax, the overpayment shall be credited or refunded as provided in section 322.

SEC. 322. REFUNDS AND CREDITS [as amended by secs. 169 (a) (b), 172 (e), Rev. Act 1942; secs. 2 (b), 4 (a) (b), Current Tax Payment Act 1943].

(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 Part II of Subchapter D or Subchapter D of Chapter 9 exceeds the taxes imposed by this chapter against which the tax so withheld may be credited under section 35 or 466 (e), 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.

(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. If any portion of the tax is paid after the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement, and if no claim for credit or refund is filed after the time of such payment and before the end of six months after the expiration of such period, then credit or refund may be allowed or made if a claim therefor is filed by the taxpayer within six months from the time of such payment, or, if no claim is filed within such six-month period after the payment, if the credit or refund is allowed or made within such period, but the amount of the credit or refund shall not exceed the portion of the tax paid during the six months immediately preceding the filing of the claim, or, if no claim was filed (and the credit or refund is allowed after six months after the expiration of the period within which the Commissioner might make an assessment), during the six months 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 or of a carry-back,

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. 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 paragraph (3), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

(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 [known as The Tax Court of the United States] within the time prescribed in such subsection, no credit or refund in respect of the tax for the taxable year in respect of which the Commissioner has determined the deficiency shall be allowed or made and no suit by the taxpayer for the recovery of any part of such tax shall be instituted in any court except—

(1) As to overpayments determined by a decision of the Board which has become final; and

(2) As to any amount collected in excess of an amount computed in accordance with the decision of the Board which has become final; and

(3) As to any amount collected after the period of limitation upon the beginning of distraint or a proceeding in court for collection has expired; but in any such claim for credit or refund or in any such suit for refund the decision of the Board which has become final, as to whether such period has expired before the notice of deficiency was mailed, shall be conclusive.

(d) *Overpayment found by Board*. If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax in respect of the taxable year in respect of which the Commissioner determined the deficiency, the Board shall have jurisdiction to determine the amount of such overpayment and such amount shall, when the decision of the Board has become final, be credited or refunded to the taxpayer. No such credit or refund shall be made of any portion of the tax unless the Board determines as part of its decision (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).

(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 Part II of Subchapter D or 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 or section 466 (e). 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). [NOTE: Under sec. 2 (d), Current Tax Payment Act 1943, the amendment of section 322 (f) by sec. 2 (b) is effective July 1, 1943. Prior to such amendment section 322 (f) read as follows: "For refund or credit in case of withholding agent, see sections 143 (f) and 466 (f)."]

§ 29.322-1 *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.

§ 29.322-2 *Credit and refund adjustments.* Overassessments and overpayments of income taxes will be adjusted by means of certificates of overassessment. Credits or refunds of overpayments on the basis of such certificates of overassessment may not be allowed or made, however, after the expiration of the statutory period of limitation properly applicable unless prior to the expiration of such period a claim therefor on Form 843 has been filed by the taxpayer. The claim, together with appropriate supporting evidence, must be filed in the office of the collector for the district in which the tax was paid. Where an amount of tax in excess of that properly due has been paid by a withholding agent, the credit or refund for 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 section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936.

§ 29.322-3 *Claims for refund by taxpayers.* Claims by the taxpayer for the refunding of taxes, interest, penalties, and additions to tax erroneously or illegally collected shall be made on Form 843, and should be filed with the collector of internal revenue. A separate claim on such form shall be made for each taxable year or period.

The claim must set forth in detail and under oath each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof. No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund. With respect to limitations upon the refunding or crediting of taxes, see § 29.322-7.

If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter a refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made in the claim showing that the return was filed by the fiduciary and that the latter is still acting. In such cases, if a refund or interest is to be paid, letters testamentary, letters of administration, or other evidence may be required, but should be submitted only upon the receipt of a specific request therefor. If a claim is filed by a fiduciary other than the one by whom the return was filed, the necessary documentary evidence should accompany the claim. The affidavit may be made by the agent of the person assessed, but in such a case a power of attorney must accompany the claim.

Checks in payment of claims allowed will be drawn in the names of the persons entitled to the money and may be sent to such persons in care of an attorney or agent who has filed a power of attorney specifically authorizing him to receive such checks. The Commissioner may, however, send any such check direct to the claimant. In this connection, see section 3477 of the Revised Statutes.

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 §§ 29.322-4 to 29.322-6, inclusive.

§ 29.322-4 *Claim for payment of judgment obtained against collector.* (a) A claim for the amount of a judgment against a collector of internal revenue for the recovery of taxes, penalties, or other sums should be made under oath, on Form 843, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment and a certificate of probable cause should be attached to the claim. If the payment of court costs is claimed, an itemized bill of the court costs paid, receipted by the clerk of the court, should also accompany the claim. With respect to the certificate of probable cause, section 989 of the Revised Statutes provides:

SEC. 989. When a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury.

If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

(b) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name, accompanied by two certified copies of the final judgment, and an itemized bill of the court costs paid. A certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, should accompany the claim. (See further § 29.322-3.)

§ 29.322-5 *Claim for payment of judgment obtained in United States district court against the United States.* A claim for the payment of a judgment rendered by a United States district court against the United States representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment should be attached to the claim. If the judgment specifically provides for the recovery of costs, an itemized bill of such court costs paid, receipted by the clerk of the court, should also accompany the claim. If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

§ 29.322-6 *Claim for payment of judgment obtained in the Court of Claims against the United States.* A claim for the payment of a judgment rendered by the United States Court of Claims against the United States, representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C., accompanied by a certificate of judgment issued by the clerk of the court and two copies of the printed opinion of the court, if an opinion was rendered. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified

copies of such waiver are furnished to the Commissioner.

§ 29.322-7 *Limitations upon the crediting and refunding of taxes paid*—(a) *General rule.* 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.

For the purposes of this section, 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 prior to 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 subsection are subject to the exceptions provided in paragraphs (b), (c), and (d) of this section.

(b) *Limitations in case waiver executed.* 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 section 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.

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 limitations on such credit or refund are those set forth in the preceding provisions of this subsection.

Credit or refund may be allowed or made more than 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 (in cases other than those described in the immediately preceding paragraph) only if such credit or refund is allowed or made within six months after the tax was paid or if claim for such credit or refund is filed within six months after such payment. In such case, the amount of the credit or refund shall not exceed the portion of the tax paid during the six months immediately preceding the filing of the claim or, if no claim was filed, the amount of the credit or refund shall not exceed the portion of the tax paid during the six months immediately preceding the allowance of the credit or refund. The 2-year period provided in section 322 (b) (1) and (2) is not applicable in any case in which the tax was paid after the execution of such an agreement.

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 paragraph (a) of this section.

The agreement referred to in this subsection will not be considered to have been executed until the date it is signed by or for the Commissioner.

(c) *Overpayment on account of bad debts, worthless securities, etc.* If the claim for credit or refund relates to an overpayment on account of:

(1) 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

(2) The effect that the deductibility of a debt or loss described in subparagraph (1) has on the application to the taxpayer of a carry-over or of a carry-back, such as the carry-over of a capital loss provided in section 117 (e) or the carry-over or carry-back of a net operating loss provided in section 122 (b),

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 paragraph (a) of this section, 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. 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 (a) or (b) of this section, whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph. Such a credit or refund can not exceed the sum of the following:

(i) The portion, if any, of the tax paid within the period provided in paragraph (a) or (b) of this section, whichever is applicable, and

(ii) The amount of overpayment due to the deductibility of items described in this paragraph.

The portion of an overpayment due to items described in this paragraph shall be determined by treating the proper deduction of such items as the first adjustment 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 7-year period described in the preceding paragraph, then credit or refund may be allowed or made only if claim therefor is filed within, or if such credit or refund is allowed or made within, any period prescribed in paragraph (a) or (b) of this section, whichever is applicable, subject to the provisions of such paragraph (a) or (b), limiting the amount of credit or refund in the case of a claim filed or, if no claim was filed, in the case of refund or credit allowed or made within such applicable period.

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

The provisions of this paragraph 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.

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).

(d) *Overpayment determined by The Tax Court.* 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 there is no deficiency but that the person has overpaid his tax for the year to which the notice of deficiency relates, and the decision of The Tax Court as to the amount overpaid has become final (see section 1140), 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 (i) of this subparagraph, but the notice of deficiency was mailed within seven years from the time prescribed for the filing of the return (determined without regard to any extension of time for filing such return), or a claim of the type described in paragraph (c) of this section was filed, that such portion of the tax does not exceed the amount of the overpayment attributable to the deductibility of items described in such paragraph (c). The amount of the overpayment attributable to the deductibility of items described in paragraph (c) of this section shall be determined under the provisions of that paragraph. For the limitation on the allowance of interest for such portion of the overpayment, see section 3771 (d).

(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 (d) (1) 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 (d) (1) of this section. (See section 1146.)

(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 § 29.275-2), 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.

§ 29.322-8 *Crediting of accounts of collectors in cases of assessments against several persons covering same liability.* If assessments have been made against several persons covering the same tax liability, and payment of such liability by one or more of such persons has been duly certified to the Commissioner, the Commissioner, for the purpose of temporarily relieving the collector from liability under section 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.

FOREIGN PERSONAL HOLDING COMPANIES

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.

§ 29.331-1 *Definition of foreign personal holding company.* A foreign personal holding company is any foreign corporation (other than a corporation exempt from taxation under section 101) which for the taxable year meets (a) the gross income requirement specified in § 29.331-2, and (b) the stock ownership requirement specified in § 29.331-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

A foreign corporation which comes within the classification of a foreign personal holding company 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.

§ 29.331-2 *Gross income requirement.* To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 334 (b) as required by section 334 (c) (2)) be foreign personal holding company income as defined in section 332:

(a) 60 percent or more; or

(b) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless:

(1) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which

the stock ownership requirement specified in section 331 (a) (2) exists; or

(2) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and §§ 29.22 (a)-1 to 29.22 (a)-20, inclusive.

§ 29.331-3 *Stock ownership requirement.* To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter referred to as "United States group." For such purpose, the ownership of the stock must be determined as provided in section 333 and §§ 29.333 (a)-1 to 29.333 (a)-7, inclusive, and § 29.333 (b)-1.

In the event of any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

SEC. 332. FOREIGN PERSONAL HOLDING COMPANY INCOME.

For the purposes of this 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).

§ 29.332-1 *Foreign personal holding company income.* For the purposes of Supplement P (sections 331 to 340, inclusive) and these regulations the term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1) and § 29.331-2 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 § 29.115-1.

(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.* The term "gains from the sale or exchange of stock or securities" as used in section 332 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 332 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the 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, 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. The term "regular dealers in stock or securities" as used in section 332 (b) means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(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.* 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:

(1) 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) 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 §§ 29.333 (a)-1 to 29.333 (a)-7, inclusive, and § 29.333 (b)-1.

The application of section 332 (e) may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation, a foreign corporation. The M Corporation enacted 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 §§ 29.333 (a)-1 to 29.333 (a)-7, inclusive, and § 29.333 (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.

SEC. 333. STOCK OWNERSHIP.

(a) *Constructive ownership.* For the purpose of determining whether a foreign corporation is a foreign personal holding company, insofar as such determination is based on stock ownership under section 331 (a) (2), section 332 (e), or section 332 (f)—

(1) *Stock not owned by individual.* Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) *Family and partnership ownership.* An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of this paragraph the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) *Options.* If any person has an option to acquire stock such stock shall be considered as owned by such person. For the purposes of this paragraph an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) *Application of family-partnership and option rules.* Paragraphs (2) and (3) shall be applied—

(A) For the purposes of the stock ownership requirement provided in section 331 (a) (2), if, but only if, the effect is to make the corporation a foreign personal holding company;

(B) For the purposes of section 332 (e) (relating to personal service contracts), or of section 332 (f) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such subsection as foreign personal holding company income.

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

(6) *Option rule in lieu of family and partnership rule.* If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

§ 29.333 (a)-1 *Stock ownership.* For the purpose of determining whether:

(a) A foreign corporation is a foreign personal holding company, in so far as such determination is based on the stock ownership requirements specified in section 331 (a) (2) and § 29.331-3, or

(b) Amounts received under a personal service contract or from the sale of such a contract constitute foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (e) and paragraph (h) of § 29.332-1, or

(c) Compensation for the use of property constitutes foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (f) and paragraph (i) of § 29.332-1,

stock owned by an individual includes stock constructively owned by him as provided in section 333. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 333 and §§ 29.333 (a)-2 to 29.333 (a)-7, inclusive, and § 29.333 (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.

§ 29.333 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (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 § 29.333 (a)-6.

§ 29.333 (a)-3 *Family and partnership ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of such determination the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in (a) of § 29.333 (a)-1 is illustrated by the following example:

Example. The M Corporation at some time during the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares		Shares		Shares		Shares		Shares	
An individual	A	100	B	20	C	20	D	20	E	20
His father	AF	10	BF	10	CF	10	DF	10	EF	10
His wife	AW	10	BW	40	CW	40	DW	40	EW	40
His brother	AB	10	BB	10	CB	10	DB	10	EB	10
His son	AS	10	BS	40	CS	40	DS	40	ES	40
His daughter by former marriage (son's half-sister)	ASHS	10	BSHS	40	CSHS	40	DSHS	40	ESHS	40
His brother's wife	ABW	10	BBW	10	CBW	10	DBW	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 333 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP) 160
B (including BF, BW, BB, BS, BSHS) 160
CW (including C, CS, CWF, CWB) 220
DB (including D, DF, DBW) 200
EWB (including EW, EWF, EWBW) 170

Total, or more than 50 percent 910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in (b) and (c) of § 29.333 (a)-1.

§ 29.333 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this 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.

§ 29.333 (a)-5 *Application of family-partnership and option rules.* The family and partnership rule provided in section 333 (a) (2) and § 29.333 (a)-3 and the option rule provided in section 333 (a) (3) and § 29.333 (a)-4 shall be applied:

(a) For the purpose stated in paragraph (a) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company, or

(b) For the purpose stated in paragraph (b) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such a contract foreign personal holding company income, or

(c) For the purpose stated in paragraph (c) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the compensation for the use of property foreign personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in § 29.333 (a)-1.

§ 29.333 (a)-6 *Constructive ownership as actual ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1:

(a) Stock constructively owned by a person by reason of the application of the rule provided in section 333 (a) (1) relating to stock not owned by an individual (see § 29.333 (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 § 29.333 (a)-3) in order to make another person the constructive owner of such stock, and

(b) Stock constructively owned by a person by reason of the application of the option rule provided in section 333 (a) (3) (see § 29.333 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 333 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 333 (a) (2) in order to make another person the constructive owner of such stock, but

(c) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 333 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

The application of this 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 § 29.333 (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.

§ 29.333 (a)-7 *Option rule in lieu of family and partnership rule.* If, in determining the ownership of stock for any of the purposes set forth in § 29.333 (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 § 29.333 (a)-(3) and the option rule provided in section 333 (a) (3) (see § 29.333 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

The application of this 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, 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 § 29.333 (a)-1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See § 29.333 (a)-6.)

However, there is more than the family and partnership rule involved in this ex-

ample. 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 § 29.333 (a)-6, such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 333 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

[SEC. 333. STOCK OWNERSHIP.]

(b) *Convertible securities.* Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) For the purpose of the stock ownership requirement provided in section 331 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a foreign personal holding company;

(2) For the purpose of section 332 (e) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such subsection as foreign personal holding company income; and

(3) For the purpose of section 332 (f) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such subsection as foreign personal holding company income.

The requirements 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.

§ 29.333 (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 1942, 1943, and 1944, those convertible in 1942 can be properly considered as outstanding stock without so considering those convertible in 1943 or 1944, and those convertible in 1942 and 1943 can be properly considered as outstanding stock without so considering those convertible in 1944. However, the securities convertible in 1943 could not be properly considered as outstanding stock without so considering those convertible in 1942 and the securities convertible in 1944 could not be properly considered as outstanding stock without so considering those convertible in 1942 and 1943.

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 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).

§ 29.334-1 *Gross income in general for purposes of Supplement P.* For all purposes of Supplement P (sections 331 to 340, inclusive) and the regulations pertaining thereto, 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 the regulations pertaining thereto, relating to the taxation of foreign corporations generally. Hence, for such purposes, the gross income includes income from all sources, whether within or without the United States, which is not excluded from gross income by section 22 (b) and the regulations pertaining to that section. The gross income thus includes the interest on bonds, notes, and certificates of indebtedness of the United States, even though owned beneficially by a foreign corporation not engaged in trade or business in the United States, and even though such interest otherwise would come within the exemption provided for in section 3 of the Fourth Liberty Bond Act of July 9, 1918, as amended by section 4 of the Victory Liberty Loan Act of March 3, 1919.

§ 29.334-2 *Additions to gross income for purposes of Supplement P.* If, for any taxable year:

(a) A foreign corporation meets the stock ownership requirement specified in § 29.331-3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(b) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company on which the United States group exists with respect to the second company,

then for the purpose of:

(c) Determining whether the first company meets the gross income requirement specified in § 29.331-2, so as to come within the classification of a foreign personal holding company, and

(d) Determining the undistributed Supplement P net income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies,

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in (b) there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed Supplement P net income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

The application of this 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, 1943, 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, 1943. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1943, 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, 1943, must be included as a dividend in the gross income of the X Corporation for 1943, since—

(a) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1943) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(b) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(c) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1943, 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 1943, 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, 1943, so that after that date no United State group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1944, 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, 1943. 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, 1944, since at one time in such fiscal year, or from July 1 to and including September 30, 1943, 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 1944, a portion of the undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1944 (3/12 of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(a) The X Corporation was a shareholder in the Y Corporation on September 30, 1943, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(b) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(c) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1944, 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, 1943, 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, 1943, 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, 1944, 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 1944, 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, 1943, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed.

If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed Supplement P net income allocable to the minority interest of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example (4). If the Y Corporation in example (1) owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed Supplement P net income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed Supplement P net income. If all three corporations are foreign personal holding companies, the undistributed Supplement P net income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain.

In the event that after the inclusion of the undistributed Supplement P net income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed Supplement P net income, would be determined independently of the income of the Y Corporation and the Z Corporation.

SEC. 335. UNDISTRIBUTED SUPPLEMENT P NET INCOME.

For the purposes of this 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 [as amended by secs. 211 (g), 212 (c), Rev. Act 1939; secs. 135 (b), 150 (h), Rev. Act 1942].

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 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 company's net income, computed without the benefit of this paragraph and section 23 (q), and without the deduction of the amount disallowed under subsection (b) of this section, and without the inclusion in gross income of the amounts includible therein as dividends by reason of the application of the provisions of section 334 (b) (relating to the inclusion in the gross income of a foreign personal holding company of its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder).

(b) *Deductions not allowed*—(1) *Taxes and pension trusts*. The deductions provided in section 23 (d), relating to taxes of a shareholder paid by the corporation, and in section 23 (p), relating to pension trusts, shall not be allowed.

(2) *Expenses and depreciation.* The aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company, shall be allowed only in an amount equal to the rent or other compensation received for the use or right to use the property, unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

(A) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) That the property was held in the course of a business carried on bona fide for profit; and

(C) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(3) *Net loss carry-over disallowed.* The deduction for net operating losses provided in section 23 (s) shall not be allowed.

(c) *1941 capital loss carry-over denied.* The net income shall be computed without regard to section 117 (e) (2).

(d) *Income not placed on annual basis.* The net income shall be computed without regard to section 47 (c).

§ 29.336-1 *Supplement P net income.* The term "Supplement P net income" means the gross income as defined in section 334 less the deductions provided in section 23 (computed without regard to the provisions of Supplement I (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), 336 (b) (3), and 336 (c), 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. Section 336 (c) provides the same treatment to foreign personal holding companies with respect to capital gains and losses as ordinary corporations except that no capital loss carry-over from the last taxable year beginning in 1941 is 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:

(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.

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 § 29.337-1), 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 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.

§ 29.336-2 *Illustration of computation of Supplement P net income and undistributed Supplement P net income.* The method of computation of the Supplement P net income and undistributed Supplement P net income may be illustrated as follows:

Example. The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1942:

The gross income of the corporation as defined in section 334 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

The expenses of the corporation amount to $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.

Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

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 sections 117 and 336 (c).

Contributions payment of which is made to or for the use of donees described in section 23 (q), for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing net income under section 21.

Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

The net income for the purposes of computing the Supplement P net income of the corporation (including the distributive share of the undistributed Supplement P net income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rented property are deductible under section 23):

Income (Section 22)

Dividends		$200,000
Interest		10,000
Rent		5,000
Gross income as defined in section 22		215,000
Add:		
Distributive share of undistributed Supplement P net income of the other foreign personal holding company (considered as a dividend)		85,000
Gross income as defined in section 334		300,000

Deductions (Section 23)

Expenses allocable to operation of the rented property	$75,000	
Depreciation of the rented property	30,000	
Ordinary and necessary expenses (office)	10,000	
Contributions (within the 5 percent limitation specified in section 23 (q))	5,000	
		120,000
Net income for purposes of computing Supplement P net income		180,000

The Supplement P net income and the undistributed Supplement P net income of the corporation are $210,875 and $160,875, respectively, computed as follows:

Net income for purposes of computing Supplement P net income			$180,000
Add (see section 336 (b)):			
Contributions deductible in computing net income under section 21	$5,000		
Excess property expenses and depreciation over amount of rent received for use of property ($105,000 − $5,000)	100,000		
		105,000	
Deduct (see section 336 (a)):			
Federal income taxes	$59,125		
Contributions within the 15 percent limitation specified in section 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 section 335)			50,000
Undistributed Supplement P net income			160,875

SEC. 337. CORPORATION INCOME TAXED TO UNITED STATES SHAREHOLDERS [as amended by sec. 126 (g), Rev. Act 1942].

(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 corporation, 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 distribution in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

(f) *Basis of stock in hands of shareholders.* The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of seven years after the date prescribed by law for filing the return.

(g) *Basis of stock in case of death.* For basis of stock or securities in a foreign personal holding company acquired from a decedent, see section 113 (a) (5).

(h) *Liquidation.* For amount of gain taken into account on liquidation of foreign personal holding company, see section 115 (c).

(i) *Period of limitation on assessment and collection.* For period of limitation on assessment and collection without assessment, in case of failure to include in gross income the amount properly includible therein under subsection (b), see section 275 (d).

§ 29.337-1 *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.* 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 § 29.331-3) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company and received by the shareholders an amount which bears the same ratio to the undistributed Supplement P net income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

The undistributed Supplement P net income of the foreign personal holding company is includible only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which the United States group existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed Supplement P net income even though the domestic corporation cannot be included within the United States group since, under section 333 (a) (1) and § 29.333 (a)-2, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed Supplement P net income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and including such last day would be equal to 100 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.

The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above specified portion of the undistributed Supplement P net income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed Supplement P net income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

The assumed distribution of the required portion of the undistributed Supplement P net income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation whose taxable year is the calendar year is a foreign personal holding company for 1942, 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 1942, and B must return his distributive share as income for the fiscal year ending November 30, 1943. 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, 1942, 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, 1943, even though September 30, 1942, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

§ 29.337-2 *Credit for obligations of the United States.* Each United States shareholder required to return his distributive share in the undistributed Supplement P net income of a foreign personal holding company for any taxable year is allowed, for purposes of the tax imposed by section 11, 13, 14, 201, 204, 207, or 362, a credit against his net income for his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in section 25 (a) (1) and (2)) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 334 (b) and § 29.334-2. (For reduction of credit for such interest on account of amortizable bond premium, see § 20.125-9.)

For example, the M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 25 (a) (1) and (2). In applying the credit allowable under section 337 (c), the United States shareholders of the M Corporation would be entitled to a credit only for their proportionate shares of the interest received by that company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation, as an actual dividend or as a constructive dividend under section 334 (b).

§ 29.337-3 *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.

§ 29.337-4 *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 1942 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 1942. 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 1942 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 1942, and if for the calendar year 1943, 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 1942, the facts otherwise being the same, the distributions in 1943 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 1942, $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.

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 prescribed 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.

§ 29.338-1 *Information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 338 (a), on the 15th day of each month 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 with the Commissioner 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:

The return for the last month of the preceding taxable year shall be filed on the 15th day of the first month following the close of such taxable year. Subsequent returns shall be filed for each 6-month period following the close of such taxable year and shall be filed on the 15th day of the first month following such period. If any change in the stock holdings or in the holdings of securities convertible into stock of the corporation occurs during such periods or if a resolution or plan (including any amendments thereof or supplements thereto) for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock is adopted during such periods a monthly information return must also be filed on the 15th day of the month following each month in which the change occurs or the resolution or plan is adopted. In any case under this paragraph where the date for filing a monthly return coincides with the date for filing the return for a 6-month period only the return for the 6-month period need be filed.

(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 collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the 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.

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.

(d) *Verification of returns.* All returns required by section 338 (a) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (a) and this section, see section 340.

§ 29.338-2 *Annual information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 338 (b), on the sixtieth day after the close of the taxable year of a foreign personal holding company each individual who on such sixtieth day is an officer or director of the corporation shall file with the Commissioner an annual information return as provided in 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 collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the 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 § 29.338-1 (c), except that if all the required returns with respect to such year have been filed under section 338 (a) and § 29.338-1, no information under section 338 (b) (2) and this paragraph need be set forth in such annual return; and

(3) Such other information as may be required by the return form.

(d) *Verification of returns.* All returns required by section 338 (b) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (b) and this section, see section 340.

§ 29.338-3 *Time and place of filing returns.* Returns required by section 338 and §§ 29.338-1 and 29.338-2 shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

SEC. 339. INFORMATION RETURNS BY SHAREHOLDERS.

(a) *Monthly returns.* On the fifteenth day of each month 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.

§ 29.339-1 *Information returns by shareholders of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* On the 15th 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 with the Commissioner 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 § 29.338-1 (a) (2).

(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 § 29.338-1, 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 collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the 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 § 29.338-1 (c).

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.

(d) *Verification of returns.* All returns required by section 339 (a) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (a) and this section, see section 340.

§ 29.339-2 *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 with the Commissioner 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 § 29.338-2, 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 collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the 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), § 29.338-1 (c), and § 29.339-1 (c), except that if all the required returns with respect to such year have been filed under section 339 (a) and § 29.339-1, no return under section 339 (b) and this section is required.

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.

(d) *Verification of returns.* All returns required by section 339 (b) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (b) and this section, see section 340.

§ 29.339-3 *Time and place of filing returns.* Returns required by section 339 and §§ 29.339-1 and 29.339-2 shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

SEC. 340. PENALTIES.

Any person required under section 338 or 339 to file a return, or to supply any information, who willfully fails to file such return, or supply such information, at the time or times required by law or regulations, shall, in lieu of the penalties provided in section 145 (a) for such offense, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than $2,000, or imprisoned for not more than one year, or both.

REGULATED INVESTMENT COMPANIES

SEC. 361. DEFINITION [as amended by sec. 170 (a), Rev. Act 1942].

(a) *In general.* For the purposes of this chapter, the term "regulated investment company" means any domestic corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in 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 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 Gov-

ernment 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, of 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.

§ 29.361-1 *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 shall be derived from dividends, interest, and gains from the sale or other disposition of stock or securities, and less than 30 percent of the corporation's gross income shall 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.* 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 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).

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. The term "controls," "controlled group," and "value" are defined for the purposes of this paragraph 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, 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 Bureau of Internal Revenue, and shall be retained as long as the contents thereof may become material in the administration of any internal-revenue law.

The requirements as to diversification under section 361 (b) (3) are 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 I, 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:

Percentage of assets invested directly in Corporation B, 20.

Percentage invested through the controlled group, Y-K-L-B, 2.4, determined as follows:

40 percent of 20 percent of 30 percent=2.4.

Percentage invested in the controlled group, Y-A-B, 3, determined by taking 30 percent of 10 percent.

Total percentage of assets of Investment Company Y invested in Corporation B, 25.4.

Example (5). Investment Company Z at the close of its first full quarter after October 21, 1942 (the date of enactment of the Revenue Act of 1942) 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 because of such distributions.

(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.

SEC. 362. TAX ON REGULATED INVESTMENT COMPANIES [as amended by secs. 209, 211 (b), Rev. Act 1939; sec. 3 (d), Rev. Act 1940; sec. 101 (c), 2d Rev. Act 1940; sec. 103 (c), Rev. Act 1941; sec. 170 (a), Rev. Act 1942].

(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) There shall be levied, collected, and paid for each taxable year upon its Supplement Q net income a tax equal to 24 per centum of the amount thereof.

(4) There shall be levied, collected, and paid for each taxable year upon its Supplement Q surtax net income a tax equal to 16 per centum of the amount thereof.

(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.

§ 29.362-1 *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.

§ 29.362-2 *Method of taxation of regulated investment companies.* 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 § 29.362-3 (relating to records required to be kept for the purpose of ascertaining the actual ownership of its outstanding stock), it is taxable upon its Supplement Q net income (as defined in section 362 (b) (1) at the rate of 24 percent of the amount thereof, upon its Supplement Q surtax net income (as defined in section 362 (b) (2)) at the rate of 16 percent of the amount thereof, and 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. If a regulated investment company does not in a particular year distribute as taxable dividends, other than capital gain dividends, to its stockholders 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). 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. 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 § 29.27 (b)-2, relating to when dividends are considered paid. Due to the provisions 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. 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.

§ 29.362-3 *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 collection district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by these regulations to be demanded from the shareholders. The term "actual owner of stock," as used in these regulations, includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection, by any authorized officer or employee of the Bureau of Internal Revenue, and shall be retained as long as the contents thereof may become material in the administration of any internal-revenue law. 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 or the approval of these regulations, whichever is later, 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.

§ 29.362-4 *Additional information required in returns of shareholders.* Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 29.362-3 requires the company to demand from its shareholders shall submit as a part of the income tax return required by the Internal Revenue Code of such person a statement showing, to the best of his knowledge and belief:

(a) 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;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposiiton of any such stock during such period and the names and addresses of the transferees thereof;

(d) 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;

(e) 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;

(f) 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 §§ 29.503 (a)-1 to 29.503 (a)-7, inclusive, and § 29.503 (b)-1; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

When making demand for the written statements required of each shareholder under these regulations, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by this 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 records required by these regulations. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by these regulations, or which may be required from time to time by any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for such purpose, shall not be taxable as a regulated investment company.

Nothing in these regulations 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.

§ 29.362-5 *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, 1942, that of a distribution of $500,000 made December 15, 1942, $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.

EXCHANGES AND DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF SECURITIES AND EXCHANGE COMMISSION

SEC. 371. NONRECOGNITION OF GAIN OR LOSS [as amended by sec. 171 (a) (b) (g), Rev. Act 1942].

(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 sub-

sidiary 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) shal 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.

[NOTE: Prior to its amendment by sec. 171 (a), Rev. Act 1942, section 371 (b) 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."]

(c) *Distribution of stock or securities only.* If there is distributed, in obedience to an order of the Securities and Exchange Commission, to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by such shareholder of stock or securities in such corporation, no gain to the distributee from the receipt of the stock or securities so distributed shall be recognized.

(d) *Transfers within system group.* (1) No gain or loss shall be recognized to a corporation which is a member of a system group (A) if such corporation transfers property to another corporation which is a member of the same system group in exchange for other property, and the exchange by each corporation is made in obedience to an order of the Securities and Exchange Commission, or (B) if there is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, property, without the surrender by such shareholder of stock or securities in the corporation making the distribution, and the distribution is made and received in obedience to an order of the Securities and Exchange Commission. If an exchange by or a distribution to a 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)[1] 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) of 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.

§ 29.371-0 *Terms used.* The following terms are defined in section 373 and when used in this section and §§ 29.371-1 to 29.373-1, inclusive, shall have the meanings therein assigned to them: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding-company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities." Any other term used in this section and §§ 29.371-1 to 29.373-1, inclusive, which is defined in the Internal Revenue Code, shall be given the respective definition contained in the Code.

§ 29.371-1 *Purpose and scope of exception.* The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 112 (a)) and that the entire amount received as a dividend is to be included in gross income (see sections 22 (a) and 115). Exceptions to the general rule are provided in section 112, one of which is that made by section 112 (b) (8) with respect to exchanges, sales, and distributions specifically described in section 371. Section 371 provides the extent to which gain or loss is not to be recognized on an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935. Section 115 (c) provides that a distribution in liquidation of a corporation shall be treated as an exchange, and such a distribution is to be so treated under the provisions of Supplement R (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

[1] Closing parenthesis evidently intended.

geographical integration of a particular public utility holding-company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 371 (f).

The requirements for nonrecognition of gain or loss as provided in section 371 are precisely stated with respect to the following four general types of transactions:

(a) 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.

(b) 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.

(c) 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.

(d) 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).

These new exceptions to the general rule are to be strictly construed as in the case of the other exceptions in section 112. Unless both the purpose and the specific requirements of Supplement R (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.

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.

§ 29.371-2 *Exchanges of stock or securities solely for stock or securities.* The exchange, without the recognition of gain or loss, that is provided for in section 371 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 371 (a), unless the stock or securities transferred and those received are stock or securities as defined by section 373 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 371 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i. e., a corporation in the same holding-company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 371 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 371 (b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 371 (a) if it is within the provisions of section 371 (d), relating to transfers within a system group. For further limitations, see section 371 (f).

§ 29.371-3 *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 Code must be determined. (See section 371 (g).) If section 371 (b) is applicable, the provisions of section 112 (other than the provisions of paragraph 8 of subsection (b)) 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), and (e) 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 subsection (f) 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 (f) and (g) of this section.

The following, for the purposes of this paragraph and paragraph (d) of this section, are treated as expenditures for property other than nonexempt property:

(i) 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);

(ii) 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

(iii) 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.

(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 ex-

pended 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) *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) 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).

(f) *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 § 29.372-2), 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 the instructions on the form or issued therewith.

(g) *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.

§ 29.371-4 *Distribution solely of stock or securities.* If, without any surrender of his stock or securities as defined in section 373 (f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 371 (c) if it is within the provisions of section 371 (d), relating to transfers within a system group. A distribution is also not within the provisions of section 371 (c) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 371 (f).

§ 29.371-5 *Transfers within system group.* The nonrecognition of gain or loss provided for in section 371 (d) 1 is applicable to an exchange of property for other property (including money and other nonexempt property). In order for any exchange to come within such section, all the parties to the exchange must be corporations which are members of the same system group. The term "system group" is defined in section 373 (d).

Section 371 (d) (1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

As stated in § 29.371-1, 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).

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 § 29.372-5) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

No exchange or distribution may be made without the recognition of gain or loss as provided for in section 371 (d) (1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 371 (d) (1) and also may be considered to be within some other provision of section 371, it shall be considered that only the provisions of section 371 (d) (1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 29.371-6 *Sale of stock or securities received upon exchange by members of system group.* Section 371 (d) (2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 371 (d) (1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required

retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 371 (d) (2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 371 (d) (2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

Example. The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange in which section 371 (d) (1) is applicable the Y Corporation on June 1, 1942, 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, 1942, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1942. The remaining $5,000 is not used to retire any of the X Corporation's stock or securties. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock only $10,000 is recognized, being the difference between the fair market value of the stock when acquired and the amount for which it was sold, since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities.

If in the above example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 29.371-7 *Exchanges in which money or other nonexempt property is received.* Under section 371 (e) (1), if in any exchange (not within any of the provisions of section 371 (d)) in which 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:

(a) 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

(b) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

If money or other nonexempt property is received from a corporation in an exchange described in this 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.

§ 29.371-8 *Requirements with respect to order of securities and exchange commission.* The term "order of the Securities and Exchange Commission" is defined in section 373 (a). In addition to the requirements specified in that definition, section 371 (f) provides that the provisions of section 371 shall not apply to an exchange, 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.

(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.

§ 29.371-9 *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.

§ 29.371-10 *Records to be kept and information to be filed with returns.* (a) Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the 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 subsection (other than 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.

SEC. 372. BASIS FOR DETERMINING GAIN OR LOSS [as amended by sec. 171 (c), Rev. Act 1942].

(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. [NOTE: Prior to its amendment by sec. 171 (c), Rev. Act 1942, 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) *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.

§ 29.372-0 *Basis for determining gain or loss.* 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. 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. 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 § 29.372-2, 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 § 29.371-1.

§ 29.372-1 *Basis of property acquired upon exchanges under section 371 (a), 371 (b) (prior to amendment by the Revenue Act of 1942), or 371 (e).* In the case of an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning prior to 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.

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 prior to 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.

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 prior to 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.

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).

§ 29.372-2 *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 sections of these 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 such subsection 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 such subsection, 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 such subsection.

(b) *General rule.* 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.

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.

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.* 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.

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 provided in the next sentence) 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).

§ 29.372-3 *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.

§ 29.372-4 *Basis of stock or securities acquired by shareholder upon tax-free distribution under section 371 (c).* Under section 372 (c), if there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 371 (c) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(a) 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.

(b) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class. As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see section 372 (d).

§ 29.372-5 *Basis of property acquired under section 371 (d) in transactions between corporations of the same system group.* If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 371 (d) (1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made.

Except as otherwise indicated in this 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 § 29.371-5.

An exception to this general rule is provided for in case the property acquired consists of stocks or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

Example. Suppose the A Corporation has property with an adjusted basis of $600,000 and in an exchange in which section 371 (d) (1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Suppose that the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the illustration in the preceding paragraph remain the same. In such case the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, and not the amount established as 500,000/1,000,000ths of $1,100,000, or $550,000.

SEC. 373. DEFINITIONS [as amended by sec. 221 (a), Rev. Act 1939, sec. 117 (a), Rev. Act 1941; sec. 171 (d) (e) (f), Rev. Act 1942].

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, § 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 stock which is preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 90 per centum of each class of the stock (other than stock which is preferred as to both dividends and assets) of at least one of the other corporations; and

(3) Each of the corporations is either a registered holding company or a majority-owned subsidiary company.

(e) The term "nonexempt property" means—

(1) Any consideration in the form of 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).

§ 29.373-1 *Definitions*—(a) *"Order of the Securities and Exchange Commission."* An order of the Securities and Exchange Commission as defined in section 373 (a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938), and must be issued under the authority of section 11 (b) or 11 (e) of the Public Utility Holding Company Act of 1935 to effectuate the provisions of section 11 (b) of such Act. 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). 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 or regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more intergrated 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 com-

pany. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

Section 11 (e) of the Public Utility Holding Company Act of 1935 provides:

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *"Registered holding company," "holding-company system," and "associate company."* Under section 5 of the Public Utility Holding Company Act of 1935 any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. The term "registered holding company" as used in these regulations means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a) (7) of the Public Utility Holding Company Act of 1935, a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i. e., an electric utility company or a gas utility company as defined by such Act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i. e., an electric utility company or a gas utility company as defined by such Act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935. An electric utility company is defined by section 2 (a) (3) of the Public Utility Holding Company Act of 1935 to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a) (4) of such Act to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company, shall not be considered an electric utility company or a gas utility company.

The term "holding-company system" has the meaning assigned to it by section 2 (a) (9) of the Public Utility Holding Company Act of 1935, and hence means any holding company, together with all its subsidiary companies (i. e., subsidiary companies within the meaning of section 2 (a) (8) of such Act, which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935. The term "member company" is defined by section 2 (a) (14) of such Act to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

The term "associate company" has the meaning assigned to it by section 2 (a) (10) of the Public Utility Holding Company Act of 1935, and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *"Majority-owned subsidiary company."* The term "majority-owned subsidiary company" is defined in section 373 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *"System group."* The term "system group" is defined in section 373 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations and the common parent corporation owns directly at least 90 percent of each class of such stock of at least one of the other corporations; but no corporation is a member of a system group if it is not either a registered holding company or a majority-owned subsidiary company. It is to be observed that while the type of stock which must be at least 90 percent owned for the purpose of this definition (i. e., stock not preferred as to both dividends and assets) may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 373 (c), yet as a general rule both types of ownership tests must be met under section 373 (d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *"Nonexempt property."* The term "nonexempt property" is defined by section 373 (e) to include:

(1) The amount of any consideration in the form of a cancellation or assump-

tion 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 of subdivision thereof).

(4) Stock or securities which are 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), as amended) 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 nonexempt 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.

TAX OF SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS

SEC. 391. APPLICABILITY OF SUPPLEMENT [as added by sec. 502, 2d Rev. Act 1940].

If a personal service corporation (as defined in section 725) 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.

§ 29.391-1 *Applicability of Supplement S.* If a personal service corporation (as defined in section 725 and the regulations thereunder) elects not to be subject to the excess profits tax for any taxable year, then Supplement S (sections 391 to 396, inclusive) 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. (See section 725 (b).)

SEC. 392. UNDISTRIBUTED SUPPLEMENT S NET INCOME [as added by sec. 502, 2d Rev. Act 1940].

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.

§ 29.392-1 *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.

SEC. 393. SUPPLEMENT S NET INCOME [as added by sec. 502, 2d Rev. Act 1940, and as amended by sec. 135 (b), Rev. Act 1942].

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).

§ 29.393-1 *Supplement S net income.* 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:

(a) The Federal income tax payable under chapter 1 for the taxable year; and

(b) 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).

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.

The provisions of the last two paragraphs of § 29.23 (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.

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 1942 a net income, as computed under chapter 1, of $190,000. The Federal income tax payable under chapter 1 for that year amounts to $45,600. 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 $124,400, 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	$45,600	
Contributions deductible under section 393 (b) (15 percent of $200,000)	30,000	
		75,600
Supplement S net income		124,400

SEC. 394. CORPORATION INCOME TAXED TO SHAREHOLDERS [as added by sec. 502, 2d Rev. Act 1940, and as amended by sec. 126 (h), Rev. Act 1942].

(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 assesssment and collection.* For period of limitation on assessment and collection without assessment, in the case of failure to include a gross income the amount properly includible therein under subsection (b), see section 275 (d).

§ 29.394–1 *Taxability of shareholders.* If, by reason of an election under section 725, a personal service corporation is exempt for any taxable year from the excess profits tax imposed under subchapter E of chapter 2, 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.

§ 29.394–2 *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 income tax), section 13 (tax on corporations in general), section 14 (tax on special classes of 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 section 362 (tax on mutual 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 § 29.125–9.)

§ 29.394–3 *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 undistributed Supplement S net income shall, for income tax 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.

§ 29.394–4 *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.

SEC. 395. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS [as added by sec. 502, 2d Rev. Act 1940].

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. 396. SHAREHOLDER'S TAX PAID BY CORPORATION [as added by sec. 502, 2d Rev. Act 1940].

If a personal service corporation is exempt for any taxable year under section 725 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 on the face of the return.

§ 29.396–1 *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 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 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 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.

INDIVIDUALS WITH GROSS INCOME FROM CERTAIN SOURCES OF $3,000 OR LESS

SEC. 400. IMPOSITION OF TAX [as added by sec. 102 (a), Rev. Act 1941, and as amended by sec. 104 (a), Rev. Act 1942].

In lieu of the tax imposed under sections 11 and 12, an individual who makes his return on the cash basis may elect, for each taxable year, to pay the tax shown in the following table if his gross income from such taxable year is $3,000 or less and consists wholly of one or more of the following: Salary, wages, compensation for personal services, dividends, interest, or annuities:

If gross income is over—	But not over—	The tax shall be— Single person (not head of a family)	Married person making separate return	(1) Married person whose spouse has no gross income or (2) Married person making joint return or (3) Head of family
$0	$525	$0	$0	$0
$525	550	1	0	0
$550	575	4	0	0
$575	600	6	0	0
$600	625	11	0	0
$625	650	15	0	0
$650	675	20	3	0
$675	700	24	6	0
$700	725	28	9	0
$725	750	33	14	0
$750	775	37	18	0
$775	800	41	22	0
$800	825	46	27	0
$825	850	50	31	0
$850	875	54	35	0
$875	900	59	40	0
$900	925	63	44	0
$925	950	67	48	0
$950	975	71	52	0
$975	1,000	76	57	0
$1,000	1,025	80	61	0
$1,025	1,050	84	65	0
$1,050	1,075	89	70	0
$1,075	1,100	93	74	0
$1,100	1,125	97	78	0
$1,125	1,150	102	83	0
$1,150	1,175	106	87	0
$1,175	1,200	110	91	0
$1,200	1,225	115	96	0
$1,225	1,250	119	100	0
$1,250	1,275	123	104	0
$1,275	1,300	128	109	1
$1,300	1,325	132	113	4
$1,325	1,350	136	117	7
$1,350	1,375	141	122	10
$1,375	1,400	145	126	14
$1,400	1,425	149	130	17
$1,425	1,450	154	135	21
$1,450	1,475	158	139	25
$1,475	1,500	162	143	29
$1,500	1,525	167	148	34
$1,525	1,550	171	152	38
$1,550	1,575	175	156	42
$1,575	1,600	180	161	47
$1,600	1,625	184	165	51
$1,625	1,650	188	169	55
$1,650	1,675	193	174	60
$1,675	1,700	197	178	64
$1,700	1,725	201	182	68
$1,725	1,750	206	187	73
$1,750	$1,775	$210	$191	$77
$1,775	1,800	214	195	81
$1,800	1,825	218	199	85
$1,825	1,850	223	204	90
$1,850	1,875	227	208	94
$1,875	1,900	231	212	98
$1,900	1,925	236	217	103
$1,925	1,950	240	221	107
$1,950	1,975	244	225	111
$1,975	2,000	249	230	116
$2,000	2,025	253	234	120
$2,025	2,050	257	238	124
$2,050	2,075	262	243	129
$2,075	2,100	266	247	133
$2,100	2,125	270	251	137
$2,125	2,150	275	256	142
$2,150	2,175	279	260	146
$2,175	2,200	283	264	150
$2,200	2,225	288	269	155
$2,225	2,250	292	273	159
$2,250	2,275	296	277	163
$2,275	2,300	301	282	168
$2,300	2,325	305	286	172
$2,325	2,350	309	290	176
$2,350	2,375	314	295	181
$2,375	2,400	318	299	185
$2,400	2,425	322	303	189
$2,425	2,450	327	308	194
$2,450	2,475	331	312	198
$2,475	2,500	335	316	202
$2,500	2,525	340	321	207
$2,525	2,550	344	325	211
$2,550	2,575	348	329	215
$2,575	2,600	353	334	220
$2,600	2,625	357	338	224
$2,625	2,650	361	342	228
$2,650	2,675	366	347	233
$2,675	2,700	371	351	237
$2,700	2,725	376	355	241
$2,725	2,750	381	359	246
$2,750	2,775	386	364	250
$2,775	2,800	391	369	254
$2,800	2,825	396	374	259
$2,825	2,850	401	379	263
$2,850	2,875	406	384	267
$2,875	2,900	411	389	271
$2,900	2,925	416	394	276
$2,295	2,950	421	399	280
$2,950	2,975	426	404	284
$2,975	3,000	431	409	289

In applying the above schedule to determine the tax of a taxpayer with one or more dependents there shall be substracted from his gross income $385 for each such dependent.

§ 29.400-1 *Scope and application of Supplement T.* For the calendar year 1942 and subsequent calendar years, in lieu of the tax imposed under sections 11 and 12, an individual who makes his return on a cash basis may elect to pay the tax imposed under section 400, if his gross income does not exceed $3,000, and if his gross income consists wholly of one or more of the following: Salary, wages, compensation for personal services, dividends, interest, or annuities. For the purposes of the $3,000 limitation, the amount of an individual's gross income shall be determined without subtracting any amount on account of such individual's dependents. For example, A, a single person who is not the head of a family, has a gross income, consisting of salary, of $3,200 for 1942. He has two dependents. For the purpose of the $3,000 limitation, his gross income is $3,200, not $2,430 ($3,200 minus $770), and consequently he may not compute his tax under Supplement T (sections 400 to 404, inclusive). An individual deriving any other kind of income, such as income from the conduct of a business or from a trust of which he is a beneficiary, or gains from the sale or exchange of property, may not compute his tax under Supplement T. If an individual derives income from a partnership of which he is a member or from a trust of which he is a beneficiary, and the partnership or trust previously derived the income distributed to him from, for example, interest, he will be considered to have received income from a partnership or trust, rather than from interest, and consequently will not be entitled to compute his tax under Supplement T.

A husband and wife living together on July 1 of the taxable year may file separate returns on Form 1040A, if the gross income of each is from the prescribed sources and does not exceed $3,000, or they may file a single joint return on such form if their combined gross income is from the prescribed sources and does not exceed $3,000. A married person living with husband or wife at any time during the calendar year may not compute the tax under Supplement T if the other spouse makes an income tax return without regard to such Supplement (see § 29.404-1).

If an individual dies before the close of the calendar year, his tax may not be determined under Supplement T. Nor may the tax of the surviving spouse of an individual who has gross income and who dies before the close of the calendar year be determined under Supplement T. (See sections 404 and 47 (g).)

In order to determine the amount of his tax an individual merely ascertains the amount of his gross income, subtracts $385 for each dependent for whom a credit is allowable and refers to the amended schedule set forth in section 400 to find the amount of his tax. If the taxpayer is the head of a family only by reason of his having one or more dependents, he may subtract from his gross income $385 for all except one of such dependents (see example (4) in § 29.401-1). If the taxpayer is a single person who is not the head of a family, his tax is set forth in the third column of the amended schedule. If the taxpayer is a married person making a separate return (but not including a taxpayer whose spouse makes a return without regard to Supplement T), the tax is set forth in the fourth column of the amended schedule. If the taxpayer is (1) a married person whose spouse has no gross income, (2) a married

person making a joint return, or (3) the head of a family, the tax is set forth in the fifth column of the amended schedule. Under the amended schedule no tax is imposed upon a single person whose gross income (less credit for dependents) does not exceed $525, or upon a married person making a separate return whose gross income less credit for dependents) does not exceed $650, or upon (1) a married person whose spouse has no gross income, (2) a married person making a joint return, or (3) the head of a family, whose gross income (less credit for dependents) does not exceed $1,275.

SEC. 401. RULES FOR APPLICATION OF SECTION 400 [as added by sec. 102 (a), Rev. Act 1941, and as amended by sec. 104 (b), Rev. Act 1942].

For the purposes of this supplement—

(a) *Definitions.* (1) "Married person" means a married person living with husband or wife on July 1 of the taxable year.

(2) "Dependent" means a person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer on July 1 of the taxable year if on such date such dependent person is under eighteen years of age, or is incapable of self-support because mentally or physically defective, excluding as a dependent, in the case of a head of a family, one who would be excluded under section 25 (b) (2) (B). 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. • •

(b) *Married and not living with husband or wife.* An individual not a head of a family and not living with husband or wife on July 1 of the taxable year shall be treated as a single person.

§ 29.401-1 *Rules for application of schedule in section 400.* For the calendar year 1942 and subsequent calendar years, the determination of whether a taxpayer is a single person, a married person, or the head of a family, or whether he has a dependent, is to be made as of July 1 of such taxpayer's taxable year.

Example (1). For the calendar year 1942, A, an unmarried person has a gross income of $2,832 derived wholly from salary and interest. During the first five months of 1942, A's status is that of head of a family, but on July 1, 1942, his status is that of a single person not the head of a family. To determine the tax imposed upon him for the calendar year 1942 under section 400, A refers to column 3 of the schedule (applicable to a single person who is not the head of a family) and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $2,825 to $2,850 is $401. Since $2,832 is within this bracket, A's tax is $401.

Example (2). For the calendar year 1942, B has a gross income of $2,312, derived wholly from salary and dividends, and C, his wife, has gross income of $671, derived wholly from wages and an annuity. On July 1, 1942, they are living together and B is supporting two dependent children, both of whom are under the age of 18. B and C file separate returns under Supplement T. To determine his tax for the calendar year 1942, B subtracts $770 from $2,312, refers to column 4 of the schedule (applicable to married person making separate return), and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $1,525 to $1,550 is $152. Since $1,542 ($2,312 minus $770) is within this bracket, B's tax is $152. To determine her tax for such year, C refers to column 4 of the schedule (applicable to married person making separate return) and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $650 to $675 is $3. Since $671 is within this bracket, C's tax is $3. Under such facts, if B and C file a joint return under Supplement T, their combined gross income is $2,983. To determine their tax, they subtract $770 and refer to column 5 of the schedule (applicable to married person making joint return) and find that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $2,200 to $2,225 is $155. Since $2,213 ($2,983 minus $770) is within this bracket, the combined tax of B and C is $155.

Example (3). For the calendar year 1942, D has a gross income of $1,860, derived wholly from wages. He was married on April 1, 1942, and he and his wife were living together on July 1, 1942. He has no dependents. His wife, who has no gross income in 1942, dies on December 1, 1942. To determine his tax for the calendar year 1942, D refers to column 5 of the schedule (applicable to a married person whose spouse has no gross income), and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $1,850 to $1,875 is $94. Since $1,860 is within this bracket, D's tax is $94.

Example (4). For the calendar year 1942, E has a gross income of $2,965. His wife, who has no gross income in 1942, dies on May 15, 1942, and on July 1, 1942, he is supporting and maintaining a home for two dependent children both of whom are under the age of 18. Since E would not occupy the status of head of a family except for the fact that he maintains a home for such children, no amount may be subtracted from gross income on account of one of such children. To determine his tax for the calendar year 1942, E subtracts only $385 and refers to column 5 of the schedule (applicable to head of family) and finds that the tax in the case of a taxpayer whose gross income falls in the bracket running from $2,575 to $2,600 is $220. Since $2,580 ($2,965 minus $385) is within this bracket, E's tax is $220. If the wife had had gross income, the tax of neither spouse could be determined under Supplement T.

Payments to a wife in the nature of, or in lieu of, alimony which are includible in her gross income under sections (22) (k) and 171 may not be considered as a payment by her husband for the support of any dependent (for definition of husband and wife for purposes of this sentence, see section 3797 (a) (17)).

SEC. 402. MANNER OF ELECTION [as added by sec. 102 (a), Rev. Act 1941].

The election referred to in section 400 shall be considered to have been made if the taxpayer files the return prescribed for this Supplement and such election shall be irrevocable. If the taxpayer for any taxable year has filed a return computing his tax without regard to this Supplement, he may not thereafter elect for such year to compute his tax under this Supplement.

§ 29.402-1 *Manner of election to compute tax under Supplement T.* A taxpayer elects to compute his income tax under Supplement T (sections 400 to 404, inclusive) by filing a return of his gross income on Form 1040A, the form prescribed for this Supplement. If a husband and wife both make such an election, they may file a joint return reporting their aggregate gross income or they may file separate returns reporting their respective gross incomes. If they file separate returns, the tax of each shall be computed by reference to the fourth column of the schedule set forth in section 400.

An election under Supplement T once made for the taxable year may not be revoked by an amended return or otherwise, but a new election is allowed for each subsequent taxable year. If for any taxable year the taxpayer makes a return without regard to Supplement T, he may not thereafter elect to have his tax computed under such supplement for that taxable year.

SEC. 403. CREDITS AGAINST TAX NOT ALLOWED [as added by sec. 102 (a), Rev. Act 1941].

Section 31 (relating to foreign tax credit) and section 32 (relating to credit for taxes withheld at source) shall not apply with respect to the tax imposed by this Supplement.

SEC. 404. CERTAIN TAXPAYERS INELIGIBLE [as added by sec. 102 (a), Rev. Act 1941, and as amended by sec. 104 (c), Rev. Act 1942].

This supplement shall not apply to a nonresident alien individual, to an estate or trust, to an individual filing a return for a period of less than twelve months or for any taxable year other than a calendar year, or to a married individual married and living with husband or wife at any time during the taxable year whose spouse files return and computes tax without regard to this supplement.

§ 29.404-1 *Taxpayer to whom Supplement T is inapplicable.* The following taxpayers are not entitled to file a return and pay tax under Supplement T:

(a) A nonresident alien individual;

(b) An estate or trust;

(c) An individual who files a return for a period of less than 12 months or for any taxable year other than a calendar year; or

d) An individual who is married and living with husband or wife at any time during the calendar year and whose spouse files an income tax return for such year without regard to Supplement T.

ABATEMENT OF TAX FOR MEMBERS OF ARMED FORCES UPON DEATH

SEC. 421. ABATEMENT OF TAX FOR MEMBERS OF ARMED FORCES UPON DEATH [as added by sec. 8, Current Tax Payment Act 1943].

In the case of any individual who dies on or after December 7, 1941, while in active service as a member of the military or naval forces of the United States or of any of the other United Nations and prior to the termination of the present war as proclaimed by the President, the tax imposed by this chapter shall not apply with respect to the taxable year in which falls the date of his death, and the tax under this chapter and under the corresponding title of each prior revenue law for preceding taxable years 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.

[*Subparts D, E, F, and G will appear in the issue for Friday, November 5, 1943.*]

[SEAL] ROBERT E. HANNEGAN,
Commissioner of Internal Revenue.

Approved: October 26, 1943.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

[F. R. Doc. 43-17458; Filed, October 28, 1943; 9:43 a. m.]

THE NATIONAL ARCHIVES OF THE UNITED STATES 1934
LITTERA SCRIPTA MANET

FEDERAL REGISTER

VOLUME 8 NUMBER 220

Washington, Friday, November 5, 1943

Regulations

TITLE 6—AGRICULTURAL CREDIT

Chapter III—War Food Administration (Farm Security)

Subchapter A—Administration

PART 300—GENERAL

APPLICABILITY OF ORDERS TO EXPENDITURE OF FUNDS UNDER ACT OF 1944

By virtue of and pursuant to the authority vested in me by the Department of Agriculture Appropriation Act, 1944, approved July 12, 1943 (Public Law 129, 78th Congress), I hereby order and direct,

§ 300.10 *Making applicable to the expenditure of funds made available by the items entitled "Farm Tenancy" and "Loans, Grants and Rural Rehabilitation" contained in the Department of Agriculture Appropriation Act, 1944, certain orders, rules, regulations, and delegations of authority issued under authority of the Department of Agriculture Appropriation Act, 1943.* (a) That the expenditure of funds appropriated, authorized or administered by or pursuant to the items of said act entitled "Loans, Grants and Rural Rehabilitation" and "Farm Tenancy" and the administration of all activities conducted with such funds shall, subject to the limitations expressed in said act, be in accordance with the orders, rules, regulations, and delegations of authority heretofore issued and in effect on the date of issuance hereof relating to the expenditure of funds appropriated or authorized to the Department of Agriculture by or pursuant to the Department of Agriculture Appropriation Act, 1943, to the extent that such orders, rules, regulations, and delegations of authority are consistent with the provisions of the Department of Agriculture Appropriation Act, 1944.

(b) That no loans, grants, or other expenditures shall be made from the funds appropriated or authorized by the Department of Agriculture Appropriation Act, 1944, under the item "Loans, Grants and Rural Rehabilitation" except such as are shown clearly by the facts to be necessary for the production of agricultural commodities.

(c) That any redelegations of authority in effect on the date of this order shall continue in effect subject to any powers heretofore granted to revoke such redelegations and subject further to the limitations in the Department of Agriculture Appropriation Act, 1944, and in this memorandum, with respect to use of funds appropriated and authorized by that act.

(d) That whenever any authority heretofore granted by the Secretary in connection with any program limited the amount of money which might be expended thereunder, such limit shall be deemed applicable to the total amount to be expended under such authorization for such program out of funds appropriated by prior acts and funds appropriated by or advanced pursuant to the Department of Agriculture Appropriation Act, 1944.

(e) The foregoing rules and regulations shall be effective as of July 1, 1943, and remain in effect until my further order.

(Pub. Law No. 129, 78th Cong.; E.O. 9322, 8 F.R. 3807, as amended by E.O. 9334, 8 F.R. 5423)

Issued this 3d day of November 1943.

MARVIN JONES,
War Food Administrator.

Approved: November 3, 1943.

CLAUDE R. WICKARD,
Secretary of Agriculture.

[F. R. Doc. 43-17885; Filed, November 4, 1943; 11:46 a. m.]

TITLE 7—AGRICULTURE

Chapter VII—War Food Administration (Sugar Determinations)

PART 802—SUGAR DETERMINATIONS

LOUISIANA SUGARCANE FOR SUGAR, 1943 CROP

NOVEMBER 3, 1943.

Pursuant to the provisions of section 301 (d) of the Sugar Act of 1937, as amended, and Executive Order No. 9322, issued March 26, 1943, as amended by Executive Order 9334, issued April 19, 1943, the following determination is hereby issued:

(Continued on next page)

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TITLE 26—INTERNAL REVENUE

Chapter I—Bureau of Internal Revenue

Subchapter A—Income and Excess-Profits Taxes

[Regulations 111]

PART 29—INCOME TAX; YEARS BEGINNING AFTER DECEMBER 31, 1941

NOTE: The table of contents and Subparts A and B appeared in the issue for Wednesday, November 3, 1943. Subpart C appeared in the issue for Thursday, November 4, 1943.

SUBPART D—VICTORY TAX ON INDIVIDUALS

RATE AND COMPUTATION OF TAX

SEC. 450. IMPOSITION OF TAX [as added by sec. 172 (a), Rev. Act 1942].

There shall be levied, collected, and paid for each taxable year beginning after December 31, 1942, a victory tax of 5 per centum upon the victory tax net income of every individual (other than a nonresident alien subject to the tax imposed by section 211 (a)).

§ 29.450-1 *Victory tax on individuals.* For taxable years beginning after December 31, 1942, and before the day following the date of cessation of hostilities in the present war (determined as provided in section 475 (b)) there is imposed, in addition to the normal tax and the surtax, upon every individual (other than a nonresident alien whose tax liability is determined under section 211 (a)) a victory tax at the rate of 5 percent (subject to the limitations provided in section 456) upon the amount of the taxpayer's victory tax net income. As to what constitutes victory tax net income, see § 29.451-1.

SEC. 451. VICTORY TAX NET INCOME [as added by sec. 172 (a), Rev. Act 1942].

(a) *Definition.* The term "victory tax net income" in the case of any taxable year means (except as provided in subsection (c)) the gross income for such year (not including gain from the sale or exchange of capital assets as defined in section 117, or interest allowed as a credit against net income under section 25 (a) (1) and (2), or amounts received as compensation for injury or sickness which are included in gross income by reason of the exception contained in section 22 (b) (5) minus the sum of the following deductions:

(1) *Expenses.* The expenses allowable as a deduction by section 23 (a) (1) and (2).

(2) *Interest.* Interest allowable as a deduction by section 23 (b), if the indebtedness in respect of which such interest is allowed was incurred in carrying on any trade or business, or was incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

(3) *Taxes.* Amounts allowable as a deduction by section 23 (c), to the extent such amounts are paid or incurred in connection with the carrying on of a trade or business, or in connection with property used in the trade or business, or in connection with property held for the production of income.

(4) *Losses.* Losses (other than losses from the sale or exchange of capital assets) allowable as a deduction under section 23 (e) (1), subject to the limitation provided in section 23 (h).

(5) *Bad debts.* The amount allowable by section 23 (k) (1).

(6) *Depreciation.* The amount allowable by section 23 (l).

(7) *Depletion.* The amount allowable by section 23 (m) and (n).

(8) *Pension trusts.* The amount allowable by section 23 (p).

(9) *Net operating loss.* The net operating loss deduction allowable by section 23 (s).

(10) *Amortization.* The amount allowable by section 23 (t).

(11) *Alimony.* The amount allowable by section 23 (u).

(12) *Special deduction.* The amount allowable by section 120.

(13) *Estates and trusts.* In the case of an estate or trust, the amount allowable by subsection (a) of section 162 in addition to the amounts allowable by subsections (b) and (c) of such section.

(b) *Items not deductible.* The deductions allowable by subsection (a) shall be subject to the limitations contained in section 24 and Supplement J and, in the case of nonresident aliens subject to the victory tax, shall be subject to the limitations contained in Supplement H.

(c) *Supplement T taxpayer.* If for any taxable year a taxpayer makes his return and pays his tax under Supplement T, the term "victory tax net income" means the gross income for such year.

(d) *Basis for determining loss.* The basis for determining the amount of deduction for losses sustained, to be allowed under paragraph (4) of subsection (a), and for bad debts, to be allowed under paragraph (5) of subsection (a), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

(e) *Rule applicable to participants in a common trust fund.* In the case of a participant in a common trust fund, he shall in respect of the common trust fund income include in computing his victory tax net income, whether or not distributed and whether or not distributable, only his proportionate share of the ordinary net income or the ordinary net loss of the common trust fund, computed as provided in section 169 (d).

(f) *Rule applicable to partners.* In the case of an individual carrying on business in partnership, he shall in respect of the partnership income include in computing his victory tax net income, whether or not distribution is made to him, only his distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

§ 29.451-1 *Gross income for victory tax purposes*—(a) *Citizens or residents of the United States.* For the purposes of the determination of victory tax net income, there are excluded from gross income: (1) Gain from the sale or exchange of capital assets as defined in section 117; (2) interest upon obligations of the United States and obligations of corporations organized under Act of Congress which are instrumentalities of the United States, if such interest is allowable as a credit against net income under the provisions of section 25 (a) (1) and (2); and (3) amounts received as compensation for injury or sickness which are included in gross income by reason of the exception contained in section 22 (b) (5). As to what constitutes interest allowable as a credit against net income, see § 29.22 (b) (4)-4.

A participant in a common trust fund shall, in respect of his share of the income of the common trust fund, include in gross income for the purpose of the determination of his victory tax net income only his proportionate share of the ordinary net income or the ordinary net loss of the common trust fund computed as provided in section 169 (d). As to computation of net income of participants in a common trust fund, see § 29.169-2.

A member of a partnership shall, in respect of his share of the income of the partnership, include in gross income for the purpose of the determination of his victory tax net income, only his distributive share (whether distributed or not) of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). As to computation of partnership income, see § 29.183-1.

(b) *Nonresident alien subject to victory tax.* Nonresident aliens falling into the following classes are subject to the victory tax: (1) Such aliens (other than residents of Canada) not engaged in trade or business within the United States but deriving during the taxable year more than $15,400 gross amount of dividends, interest, and other fixed or determinable annual or periodical income from sources within the United States; and (2) such aliens who at any time during the taxable year are engaged in trade or business within the United States. Nonresident aliens not engaged in trade or business within the United States and deriving during the taxable year not in excess of $15,400 gross amount of dividends, interest, and other fixed or determinable annual or periodical income from sources within the United States, and such nonresident aliens who are residents of Canada (regardless of the amount of their fixed or determinable annual or periodical income from sources within the United States), are not subject to the victory tax. In the case of a nonresident alien subject to the victory tax, the gross income adjusted as indicated in section 451 (a) means only gross income from sources within the United States. As to what constitutes gross income from sources within the United States in such cases, see sections 119 and 212 (a), and §§ 29.212-1, 29.212-2, and 29.211-7.

(c) *United States citizens entitled to benefits of section 251.* In the case of United States citizens entitled to the benefits of section 251, gross income for the purposes of the victory tax means only gross income from sources within the United States plus all amounts received by such citizens within the United States whether derived from sources within or without the United States, the sum of such amounts being reduced by the items, if any, excluded from gross income under paragraph (a) of this section. See § 29.251-1.

§ 29.451-2 *Victory tax net income*—(a) *Citizen or resident of the United States.* The term "victory tax net income" in the case of a citizen or resident of the United States means gross income, adjusted as described in § 29.451-1 (a), less the deductions provided in the case of individuals under section 23 relating to deductions from gross income, subject, however, to the qualifications, limitations, and exceptions with respect to such deductions provided in section 451 and this section. The deductions, therefore, from gross income (as defined in § 29.451-1 (a) allowable for the pur-

poses of the determination of victory tax net income are those set forth in section 23 and the regulations thereunder, subject, however, to the following qualifications, limitations, and exceptions:

(1) *Interest.* The deduction generally allowable for interest under the provisions of section 23 (b) is allowable for the purposes of the victory tax if, and only if, the indebtedness with respect to which such interest is allowed was incurred:

(i) In carrying on any trade or business;

(ii) For the production or collection of income; or

(iii) For the management, conservation, or maintenance of property held for the production of income.

Hence, for example, interest upon indebtedness representing a mortgage upon the home of the taxpayer is not deductible for the purposes of the victory tax. Interest upon indebtedness incurred incident to the acquisition of property held for investment, even though it actually produces no income during the taxable year, is nevertheless deductible. For the treatment of interest as a deduction from gross income generally, see section 23 (b) and the regulations thereunder.

(2) *Taxes.* The deduction generally allowable for taxes paid or incurred under the provisions of section 23 (c) is allowable for the purposes of the victory tax if, and only if, paid or incurred:

(i) In connection with the carrying on of a trade or business;

(ii) In connection with property used in the trade or business; or

(iii) In connection with property held for the production of income.

Hence, for example, taxes paid by the taxpayer with respect to ownership of his home are not deductible for this purpose. Likewise, automobile license fees are not deductible for victory tax purposes except in the case of automobiles used in connection with the carrying on of a trade or business. Taxes are not deductible which are paid or incurred by reason of ownership of property held by the taxpayer primarily as a sport, hobby, or recreation. The deduction for retail sales taxes provided in section 23 (c) (3) is not applicable for victory tax purposes. Income, war profits, or excess profits taxes paid to a foreign country or to a possession of the United States are not deductible if the taxpayer chooses to take to any extent for such taxable year the benefits of section 131 relating to the credit for foreign taxes even though no credit is allowed for such taxes against the victory tax. Such taxes are deductible for victory tax purposes only when deducted for income tax purposes under the provisions of section 23 (c) and then only if they qualify under the limitations prescribed in this paragraph. See section 23 (c) (1) (C) and § 29.23 (c)-1. For the treatment of taxes as a deduction from gross income generally, see section 23 (c) and the regulations thereunder.

(3) *Losses.* Only losses allowable as a deduction under section 23 (e) (1) because incurred in trade or business are deductible. Wagering losses so incurred are allowable only to the extent of gains from such transactions. Losses from the sale or exchange of capital assets including losses from worthless securities governed by section 28 (k) (2), even though sustained in trade or business, are not deductible. The basis for determining the amount of allowable losses sustained for the purposes of the victory tax is the adjusted basis for determining the loss from the sale or other disposition of the property. For treatment of such losses generally, see sections 23 (e) (1), 23 (i), 113 (b), and the regulations thereunder.

(4) *Bad debts.* Only bad debts deductible under section 23 (k) (1) are allowable for victory tax purposes. Nonbusiness bad debts as defined in section 23 (k) (4) are not deductible nor is any deduction permitted on account of a worthless debt evidenced by a security as defined in section 23 (k) (3) and allowable for income tax purposes to the extent permitted by section 23 (k) (2). For treatment of bad debts generally, see section 23 (k) and the regulations thereunder.

(5) *Contributions.* The deduction for charitable and other contributions allowed generally under the provisions of section 23 (o) is not allowable for the determination of the victory tax net income except, however, that in the case of any individual who qualifies under the provisions of section 120, the deduction for contributions is allowable under section 23 (o) without regard to the percentage limitation contained therein. See § 29.120-1. In the case of estates or trusts, however, the deductions provided in section 162 (a) with respect to contributions as well as those in section 162 (b) and (c) with respect to distributions by the estate or trust are allowable. See section 162 and § 29.162-1.

(6) *Specific unallowable items.* The following items allowable generally as deductions from gross income for the purposes of normal tax and surtax are not allowable for the purposes of determining victory tax net income:

(i) The deduction for amortization of bond premium provided in section 125;

(ii) The deductions allowed estates, etc., on account of decedent's deductions provided in section 23 (w);

(iii) The deduction for medical, dental, etc., expenses provided in section 23 (x);

(iv) The deduction for certain amounts paid to cooperative apartment corporations provided in section 23 (z).

(7) *Items not deductible generally.* In addition to the deductions generally allowable under chapter 1 but disallowed for the purposes of the determination of the victory tax net income as set forth in subparagraphs (1) to (6), inclusive, there are also disallowed for the purposes of the determination of the victory tax net income those additional items disallowed generally under the provisions of section 24. See §§ 29.24-1 to 29.24-7, inclusive.

(b) *Nonresident aliens.* In addition to the qualifications, limitations, and exceptions contained in subparagraphs (1) to (7), inclusive, of paragraph (a) of this section, the general rules with respect to deductions for the purposes of the normal tax and the surtax in the case of nonresident aliens are likewise applicable to such aliens for the purposes of the victory tax. Such deductions are allowable only if and to the extent that they are connected with income from sources within the United States. See section 213 and § 29.213-1.

(c) *United States citizen entitled to benefits of section 251.* In addition to the qualifications, limitations, and exceptions contained in paragraphs (a) (1) to (a) (7), inclusive, of this section, the general rules with respect to deductions for the purposes of the normal tax and the surtax in the case of a citizen of the United States entitled to the benefits of section 251 are also likewise applicable in the case of such citizens for the purposes of the victory tax. Such deductions are allowable only if and to the extent that they are connected with income from sources within the United States. See section 251 (e) (1) and § 29.251-5.

(d) *Supplement T taxpayer.* If for any taxable year an individual citizen or resident of the United States makes his return and pays his tax under Supplement T (sections 400 to 404, inclusive), relating to individuals with gross income from certain sources of $3,000 or less, then the victory tax net income means gross income for such year and the provisions of section 451 and of this section relating to deductions from gross income have no application to such case.

SEC. 452. SPECIFIC EXEMPTION [as added by sec. 172 (a), Rev. Act. 1942].

In the case of every individual there shall be allowed as a credit against the victory tax net income a specific exemption of $624. In the case of a husband and wife filing a joint return under section 51 (b), if the victory tax net income of one spouse is less than $624, the aggregate specific exemption of both spouses shall be limited to $624 plus the victory tax net income of such spouse.

§ 29.452-1 *Specific exemption.* For the purposes of computing the victory tax, there is allowed against the victory tax net income but one credit, namely, a specific exemption of $624. The credits, therefore, provided in section 25 with respect to normal tax or surtax, or both, have no application for the purposes of the victory tax. Except as otherwise provided in the case of a husband and wife making a joint return, the full exemption of $624 is allowable to each taxpayer regardless of dependents or the personal status of the taxpayer. In the case of a return for a fractional part of a year, as, for instance, the return for a decedent, the $624 exemption is not required to be prorated but is allowable in full. In the case of husband and wife making separate returns for the taxable year, each is entitled to a specific exemption of $624. In the case of husband and wife making a joint return for the taxable year, if the victory tax net income of one spouse is less than $624, the aggregate specific exemption of both

spouses amounts to $624 plus the victory tax net income of such spouse. Thus, if A and his wife B make a joint return for the year 1943 and B has victory tax net income of $300, the total specific exemption for both spouses in such case is $924. In any such case in which a specific exemption of more than $624 is claimed, the facts with respect to the victory tax net income of the respective spouses shall be set forth in an appropriate schedule attached to the return. The principles applicable for the determination of net income of the respective spouses for normal tax and surtax purposes are likewise applicable with respect to what constitutes victory tax net income of the respective spouses, subject, however, to the qualifications, limitations, and exceptions provided in section 451. See section 22 and the regulations thereunder.

SEC. 453. CREDIT AGAINST VICTORY TAX [as added by sec. 172 (a), Rev. Act. 1942].

(a) *Allowance of credit.* There shall be allowed as a credit against the victory tax for each taxable year:

(1) The amount paid by the taxpayer during the taxable year as premiums on life insurance, in force on September 1, 1942, upon his own life, or upon the life of his spouse, or upon the life of any dependent of the taxpayer specified in section 25 (b) (2) (A); and the amount paid during the taxable year as premiums on life insurance which is a renewal or conversion of such life insurance in force on September 1, 1942, to the extent that such premiums do not exceed the premiums payable on such life insurance in force on September 1, 1942.

(2) The amount by which the smallest amount of indebtedness of the taxpayer outstanding at any time during the period beginning September 1, 1942, and ending with the close of the preceding taxable year, exceeds the amount of indebtedness of the taxpayer outstanding at the close of the taxable year.

(3) The amount by which the amount of obligations of the United States owned by the taxpayer on the last day of the taxable year exceeds the greater of (A) the amount of such obligations owned by the taxpayer on December 31, 1942, or (B) the highest amount of such obligations owned by the taxpayer on the last day of any preceding taxable year ending after December 31, 1942. As used in this paragraph (i) the term "owned by the taxpayer" shall include the amount of the obligations owned solely by the taxpayer and one-half of the amount of the obligations owned jointly by the taxpayer with one other person, but shall not include such obligations acquired by the taxpayer by gift, or inheritance, or otherwise than by purchase; (ii) the term "obligations of the United States" means such obligations of the United States as the Secretary may by regulations prescribe, and as are purchased in such manner and under such terms and conditions as he may specify; and (iii) the term "amount of obligations of the United States" means the amount paid for such obligations.

(b) *Limitation on credit.* The amount of such credit for the taxable year shall not exceed the amount of the post war credit or refund allowed by section 454 for such taxable year.

§ 29.453-1 *Credit against victory tax*—(a) *General.* Section 453 permits a taxpayer subject to the victory tax to apply as a credit against such tax for each taxable year all or a portion of the following items (but in an amount not in excess in any event of the post war credit or refund allowed by section 454 for such taxable year):

(1) Premiums paid by the taxpayer on life insurance;

(2) Reduction in indebtedness of the taxpayer;

(3) Increase in taxpayer's holdings of certain United States obligations.

The credit provided in section 453 does not reduce the amount of the victory tax to be withheld at the source as provided in section 466. Such credit is applied against the amount of the victory tax as shown by the taxpayer's victory tax return. The taxpayer is not required to avail himself of such credit. In such event he will be entitled to the post war credit or refund with respect to such taxable year provided in section 454.

(b) *Special items of the credit*—(1) *Premiums paid by taxpayer on life insurance.* In order to secure credit for life insurance premiums paid by the taxpayer during the taxable year, there must be in force on September 1, 1942, life insurance upon the taxpayer's own life or upon the life of his spouse or upon the life of any dependent of the taxpayer as specified in section 25 (b) (2). The amount of the post war credit or refund which may be applied as a credit against the victory tax for the taxable year by reason of payment of insurance premiums is the amount paid by the taxpayer during the taxable year as premiums upon such life insurance. If any such life insurance so in force on September 1, 1942, is renewed or converted after such date, the credit includes premiums paid with respect to such renewed or converted life insurance but the credit therefor can not exceed the amount of the annual premiums payable on such insurance in force on September 1, 1942. In computing the amount of the credit under section 453 (a) (1), no account is to be taken of any life insurance policy taken out after September 1, 1942, and not representing renewal or conversion of a life insurance policy in force on such date. In computing the amount of premiums paid by the taxpayer under section 453 (a) (1), there shall be deducted from the gross amount of premiums paid during the taxable year the amount of dividends received during such taxable year which represents return of premiums.

(2) *Reduction in indebtedness of the taxpayer.* The amount of the post war credit or refund which may be applied as a credit against the victory tax for the taxable year by reason of reduction, if any, in the indebtedness of the taxpayer is the excess of the smallest amount of such indebtedness outstanding at any time during the period beginning with September 1, 1942, and ending with the close of the taxable year preceding the year for which the tax is being computed, over the amount of such indebtedness outstanding at the close of the taxable year. As used in section 453 (a) (2), the term "indebtedness" means all indebtedness for which the taxpayer is liable, whether secured or unsecured and whether or not evidenced by writing. It does not include a mere contingent or secondary liability. However, if and when a contingent liability for the payment of money becomes absolute, it is includible as indebtedness. The term includes indebtedness assumed by the taxpayer even though such indebtedness is evidenced so far as the taxpayer is concerned, only by a contract with the person whose indebtedness has been assumed. An assumption of indebtedness includes, in addition to the customary forms of assumption, the acquisition of property subject to indebtedness. In order for any indebtedness to be included within the term, it must be bona fide.

The application of section 453 (a) (2) may be illustrated by the following example:

Example. A had outstanding as of September 1, 1942, a mortgage upon his home in the amount of $5,000 which had been reduced to $4,500 as of December 31, 1942, and to $4,250 on December 31, 1943. In such case the potential credit against the victory tax by reason of reduction of indebtedness is $4,500 minus $4,250, or $250, but such latter amount is subject to the limitation that it can not in any event exceed the amount of post war credit or refund provided in section 454.

(3) *Increase in holdings of United States obligations.* The amount of the post war credit or refund available to the taxpayer as a credit against the victory tax for the taxable year by reason of increase in his holdings of United States obligations is measured by the excess of the amount of such obligations owned by the taxpayer as of the close of the last day of the taxable year over whichever of the following amounts is the greater: (i) the amount of such obligations owned by the taxpayer as of the close of the calendar year 1942, or (ii) the largest amount of such obligations owned by the taxpayer as of the close of the last day of any preceding taxable year ending after December 31, 1942.

As used in section 453 (a) (3), the term "owned by the taxpayer" includes only such obligations as have been acquired by the taxpayer by purchase and does not include obligations acquired by gift or inheritance. Obligations acquired by purchase include obligations acquired by the taxpayer under such circumstances that their acquisition results in the recognition of income to him. For purposes of the victory tax credit, if an obligation is registered in the names of two persons as co-owners, each shall, in the absence of evidence to the contrary, be presumed to be a purchaser and shall be entitled to the credit to the extent of one-half of the purchase price thereof. If, however, the entire purchase price is contributed by one co-owner, he may, if he so elects at the time of filing his first return under the victory tax subsequent to the purchase of the obligation, be considered to be the sole owner, in which case he shall be entitled to a credit to the full extent of the purchase price and no credit shall be allowed to the other co-owner. For the purposes of section 453 (a) (3), a United States savings bond registered, for example, in the name of A, payable on death to B, is not owned jointly but is owned solely by A. The term "obliga-

tions of the United States" for the purposes of the credit means only United States savings bonds, Series E, F, and G, which are purchased in such manner and under such terms and conditions as the Secretary may by regulations prescribe, subject, however, to the right of the Secretary by regulations at any time to restrict, amplify, or extend the class or classes of United States obligations with respect to which the taxpayer may be entitled to a credit under the provisions of section 453 (a) (3) and the manner, terms, and conditions under which obligations may be purchased. See Treasury Department Circular No. 704, approved December 29, 1942. The date as of which the bond is issued (month and year, as entered on the face panel, but not in the dating stamp of the issuing agent) shall be held to be the date of acquistion. The term "amount of obligations" as used in section 453 (a) (3) means the amount paid for the obligations and not the par value thereof and does not include the interest, if any, accrued thereon.

The application of section 453 (a) (3) may be illustrated by the following example:

Example. A and his wife B file a joint return for the calendar year 1943. On December 31, 1942, A owned a United States savings bond, Series E, of a part value of $500 for which he and his wife had previously paid the amount of $375, the bond being registered in the name of A or his wife B. During 1943 A and B purchased additional bonds of a par value of $200 of the same series of United States savings bonds for which they paid $150, such bonds being registered in the same manner as the bond previously purchased. They also acquired by inheritance a similar bond in the denomination of $1,000. The three bonds were held as of the close of the calendar year 1943. Since the $1,000 bond had been acquired by inheritance, such obligation has no effect upon the credit against the victory tax. Since A and B file a joint return, they are entitled to a credit under section 453 (a) (3) of $150, the difference between $525 (the amount owned at the end of 1943) and $375 (the amount owned as of December 31, 1942), subject to the limitation that such credit can not in any event exceed the amount of the post war credit or refund allowed by section 454. If A and B file separate returns, each would be entitled to a credit of $75, subject to the limitations prescribed under section 454.

For the application as a credit against the victory tax (adjusted for the credit allowed by section 453) of the tax withheld at the source under section 466, see § 29.466-5.

SEC. 454. POST WAR CREDIT OR REFUND OF VICTORY TAX [as added by sec. 172 (a), Rev. Act 1942].

(a) *Allowance of credit.* As soon as practicable after date of cessation of hostilities in the present war (as defined in section 475 (b)), the following amount of the victory tax paid for each taxable year beginning after December 31, 1942, shall be credited against any income tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer:

(1) In the case of a single person or a married person not living with husband or wife, 25 per centum of the victory tax or $500, whichever is the lesser.

(2) In the case of the head of a family, 40 per centum of the victory tax or $1,000, whichever is the lesser. In the case of a married person living with husband or wife where separate returns are filed by each spouse, 40 per centum of the victory tax or $500, whichever is the lesser. In the case of a married person living with husband or wife where a separate return is filed by one spouse and no return is filed by the other spouse, or in the case of a husband and wife filing a joint return under section 51 (b), only one such credit shall be allowed and such credit shall not exceed 40 per centum of the victory tax or $1,000, whichever is the lesser.

(3) For each dependent specified in section 25 (b), excluding as a dependent, in the case of a head of a family, one who would be excluded under section 25 (b) (2) (B), 2 per centum of the victory tax or $100, whichever is the lesser.

(b) *Change of status.* If for any taxable year the status of the taxpayer (other than a taxpayer who makes his return any pays his tax under Supplement T) with respect to his marital relationship or with respect to his dependents, changed during the taxable year, the amount of the credit or refund provided by this section for such taxable year shall be apportioned, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, in accordance with the number of months before and after such change. For the purpose of such apportionment a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

(c) *Status of Supplement T taxpayer.* If for any taxable year a taxpayer makes his return and pays his tax under Supplement T, for the purpose of the credit or refund provided by this section, his status for such year with respect to his marital relationship or with respect to his dependents shall be determined in accordance with the provisions of section 401.

(d) *Period of limitation.* No post war credit or refund of any part of the victory tax provided in this section shall be allowed or made after 7 years from the date of cessation of hostilities in the present war, unless claim for credit or refund is filed before the expiration of such date. No interest shall be allowed on such credits or refunds.

(e) *Limitation of credit.* The post war credit or refund allowed by this section shall be reduced by the amount of any credit allowed under section 453.

§ 29.454-1 *Post war credit or refund*—(a) *General.* Section 454 provides that, as soon as practicable after the cessation of hostilities in the present war (as defined in section 475 (b)), there shall be credited or refunded to the taxpayer certain designated amounts representing portions of the victory tax paid for taxable years beginning after December 31, 1942, but not in excess of certain percentages of the amount of the victory tax, such percentages being conditioned upon the marital status of the taxpayer and the number of his dependents during the year or years for which such victory tax was imposed. Such post war credit or refund applies even though there has been no previous allowance for any taxable year of the annual victory tax credit provided under section 453. However, the amount of the post war credit or refund is reduced by the aggregate amount of the annual victory tax credit previously allowed. See section 454 (e). Such post war credit or refund, to the extent it is not reduced by the amount of the annual credit previously claimed and allowed, shall be credited after the cessation of hostilities in the present war against any income tax or installment thereof then due from the taxpayer and any balance shall be refunded immediately to the taxpayer. See section 454 (d) and § 29.454-3.

(b) *Limitations on amount of post war credit or refund.* The post war credit or refund provided in section 454 is subject to the following limitations:

(1) *Single person or married person not living with husband or wife.* 25 percent of the amount of the victory tax, or $500, whichever is the lesser.

(2) *Married person living with husband or wife where separate returns are filed by each spouse.* 40 percent of the victory tax, or $500, whichever is the lesser.

(3) *Head of a family.* 40 percent of the victory tax, or $1,000, whichever is the lesser.

(4) *Married person living with husband or wife where separate return is filed by one spouse and no return is filed by the other spouse.* 40 percent of the amount of the victory tax, or $1,000, whichever is the lesser.

(5) *Married person living with husband or wife where joint return is filed.* 40 percent of the amount of the victory tax, or $1,000, whichever is the lesser.

If the taxpayer has one or more dependents for whom a credit would be allowable under section 25 (b) (2), the limitations prescribed in subparagraphs (1) to (5), inclusive, shall, for each such dependent, be increased by the addition of 2 percent to the percentage limitation and $100 to the dollar limitation. For example, in the circumstances described in subparagraph (1) if a taxpayer has one dependent, the limitations prescribed would be increased to 27 percent of the victory tax, or $600, whichever is the lesser. In the circumstances described in subparagraph (3) if the taxpayer has three dependents, but the credit for one of such dependents is disallowed by reason of the provisions of section 25 (b) (2) (B), the percentage limitations would be increased by 2 percent for each of two dependents and the dollar limitation by $100 for each of two dependents. Consequently, the limitation on the credit for victory tax purposes would be 44 percent of the victory tax, or $1,200, whichever is the lesser.

As to what constitutes dependency under section 25, see § 29.25-6.

In the application of the provisions of section 454, if a taxpayer files his return for any taxable year under Supplement T (sections 400 to 404, inclusive), his status for such taxable year as to his marital relationship and with respect to his dependents, for the purpose of the post war credit or refund, shall be determined in accordance with the special rules prescribed in section 401. See §§ 29.401-1 and 29.454-2.

The following examples illustrate the computation of the post-war credit or refund and the operation of the limitations with respect thereto in cases involving joint and separate returns of husband and wife:

Example (1). For 1943 a husband and wife with two dependents file a joint return and have a victory tax net income (after specific exemption) of $60,000.

Victory tax (5 percent of $60,000)		$3,000
Post war refund:		
44 percent of victory tax	$1,320	
or		
$1,000 plus $200	1,200	
whichever is the lesser		1,200

Example (2). For 1943 a husband and wife with two dependents (supported by the husband) file separate returns. The husband has a victory tax net income (after specific exemption) of $40,000 and the wife has a victory tax net income (after specific exemption) of $20,000.

Computation for husband:		
Victory tax (5 percent of $40,000)		$2,000
Limitation:		
44 percent of victory tax	$880	
or		
$500 plus $200	700	
whichever is the lesser		700
Computation for wife:		
Victory tax (5 percent of $20,000)		1,000
Limitation:		
40 percent of victory tax	400	
or		
$500	500	
whichever is the lesser		400
Recapitulation:		
Credit or refund of husband		700
Credit or refund of wife		400
		1,100

In the application of section 454 (a) to a nonresident alien subject to the victory tax, the provisions of section 214, relating to exemption and credits in the case of such taxpayer, shall be applicable and hence the additional credit for dependents provided in section 454 (a) (3) is allowed only if such taxpayer is a resident of a contiguous country.

§ 29.454-2 *Post war credit or refund where status changes during the taxable year*—(a) *General.* If the status of the taxpayer (other than a taxpayer who makes his return and pays his tax under Supplement T) with respect to his marital relationship or with respect to his dependents changes during the taxable year, the amount of the post war credit or refund under section 454 and § 29.454-1 shall be apportioned according to the number of months during which the taxpayer occupied each status. For the purposes of the apportionment, a fractional part of a month shall be disregarded unless it amounts to more than one-half of a month in which case it shall be considered as a month. In general, the post war credit or refund in the case of any taxpayer whose status as set forth above changed during the taxable year will be the sum of the amounts apportioned to the respective periods during which each status was occupied. If married persons file a joint return for a taxable year in which a change in the marital status has occurred, then, for the purpose of computing the credit or refund applicable to that portion of such taxable year preceding the change of status, one-half of the joint victory tax shall be attributed to each spouse. These principles may be illustrated by the following examples:

Example (1). A and B were married on August 10, 1943, each having the status of a single person prior to such date. They have no dependents. They had a combined victory tax net income (before the specific exemption) of $25,248. The victory tax net income of each is in excess of $624. They file a joint return for 1943. The post war credit or refund in such case is computed as follows:

Victory tax for 1943 on basis of joint return (5 percent of $24,000 ($25,248 minus $1,248))	$1,200
Post war credit or refund:	
Seven months January to July, inclusive	
A. Limitation on post war credit or refund (7/12×(25 percent of $600) or 7/12 of $500).	
Post war credit or refund equals	$87.50
(The figure of $87.50 applies since it is less than 7/12 of $500.)	
B. Limitation on post war credit or refund (7/12×(25 percent of $600 or 7/12 of $500).	
Post war credit or refund equals	87.50
(The figure of $87.50 applies since it is less than 7/12 of $500.)	
Five months August to December, inclusive	
Limitation on post war credit or refund (5/12×(40 percent of $1,200) or 5/12 of $1,000).	
Post war credit or refund	$200.00
(The figure of $200 applies since it is less than 5/12 of $1,000.)	
Recapitulation—Post war credit or refund	
Apportioned to A	$87.50
Apportioned to B	87.50
Apportioned to A and B jointly	200.00
Total for A and B	375.00

Example (2). A, a widower having two dependent children under 18 years of age, married B on July 1, 1943. They filed a joint return for the calendar year 1943 showing victory tax net income of $61,248 (before the application of the specific exemption) and a victory tax of $3,000. The victory tax net income of each exceeded the specific exemption of $624. The post war credit or refund in such case is computed as follows:

First half of year	
A. Limitation on post war credit or refund (1/2×(42 percent of $1,500) or 1/2 of $1,100).	
Post war credit or refund	$315.00
(This figure applies since it is less than 1/2 of $1,100.)	
B. Limitation on post war credit or refund (1/2×(25 percent of $1,500) or 1/2 of $500).	
Post war credit or refund	187.50
(This figure applies since it is less than 1/2 of $500.)	
Second half of year	
Limitation on post war credit or refund (1/2 of (44 percent of $3,000) or 1/2 of $1,200).	
Post war credit or refund	$600.00
(This figure applies since it is less than 1/2 of (44 percent of $3,000).)	
Recapitulation—Post war credit or refund	
Apportioned to A	$315.00
Apportioned to B	187.50
Apportioned to A and B jointly	600.00
Total	1,102.50

(b) *Status of Supplement T taxpayer.* In the case of a taxpayer making his return and paying his tax under Supplement T (sections 400 to 404, inclusive), relating to the optional tax on individuals with gross income from certain sources of $3,000 or less, the status of such taxpayer shall be determined by the application of the following rules:

(1) His status both with respect to marital relationship and with respect to dependents is to be determined as of July 1 of each taxable year.

(2) If such taxpayer is not the head of a family and is not living with husband or wife or is unmarried as of July 1 of the taxable year, he shall be treated as a single person, even though in fact he may become the head of a family or be married during the taxable year subsequent to July 1.

If, for example, A and his wife B are not living together on July 1, 1943, and for the calendar year 1943 they elect to pay the tax under Supplement T, they are considered as single persons for income and victory tax purposes and hence each must file a separate return. In such case, the limitation on the post war credit or refund is determined under section 454 (a) (1) and shall in each case be 25 percent of the victory tax or $500, whichever is the lesser. However, in the case of a husband and wife living together on July 1, 1943, they may elect to file either joint or separate returns under Supplement T. If they elect to file separate returns, the limitation provided in section 454 (a) (2) applicable generally in the case of husband and wife filing separate returns is here likewise applicable and hence the post war credit or refund (without regard to dependents) cannot, in the case of each spouse, exceed 40 percent of the victory tax or $500, whichever is the lesser. If such husband and wife elect to file a joint return, the limitation on the post war credit or refund provided in section 454 (a) (2) applicable generally in respect of husband and wife filing a joint return is here applicable and such credit (without regard to dependents) cannot exceed 40 percent of the victory tax or $1,000, whichever is the lesser.

Payments made by the husband to the wife of an amount which is includible in her gross income by reason of section 22 (k) and section 171 shall not be considered as payment by the husband for the support of any dependent.

§ 29.454-3 *Period of limitation for making post war credit or refund.* The post war credit or refund provided in section 454, to the extent such credit or refund is not applied under section 453 as a credit against the victory tax, cannot be made after seven years from the date of cessation of hostilities in the present war (as that term is defined in section 475 (b)) unless claim for credit or refund thereof is filed with the collector of internal revenue before the expiration of such 7-year period. No interest is allowable upon such credits or refunds of the victory tax. For the manner of filing claims for refund or credit generally, see § 29.322-3.

SEC. 455. RETURNS [as added by sec. 172 (a), Rev. Act 1942].

(a) *Individual returns.* Every individual having a gross income in excess of $624 for the taxable year, shall make, under regulations prescribed by the Commissioner with the approval of the Secretary, a return, which shall contain or be verified by a written declaration that it is made under the pen-

alties of perjury, stating specifically the items of his gross income and the deductions and credits allowed under this subchapter.

(b) *Fiduciary returns.* Every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make, under regulations prescribed by the Commissioner with the approval of the Secretary, a return under oath, for any individual, estate, or trust for which he acts, if the gross income of such individual, estate, or trust is in excess of $624 for the taxable year, stating specifically the items of gross income and the deductions and credits allowed under this subchapter. The provisions of section 142 (b) shall be applicable with respect to any return required to be made under this subsection.

§ 29.455-1 *Returns*—(a) *Individuals.* For taxable years beginning after December 31, 1942, there shall be made a victory tax return by each citizen of the United States whether residing within or without the United States, by every individual residing within the United States though not a citizen thereof, by every nonresident alien individual (other than a nonresident alien individual subject to the tax imposed by section 211 (a)), whether or not such citizen or resident or nonresident alien individual is the head of a family or has dependents, if such citizen, resident or alien has a gross income (computed without regard to the exclusion from gross income provided in section 451 (a)) for the taxable year in excess of $624. In the case of nonresident alien individuals, such gross income means only gross income from sources within the United States.

If a return is required for normal tax and surtax purposes or, in the alternative, for the purposes of the tax under Supplement T (sections 400 to 404, inclusive), the return for victory tax purposes shall be made a part of such return. If, under the limitations contained in section 51 (a), the gross income of the taxpayer is insufficient to require a return for normal tax and surtax purposes, a return for victory tax purposes shall, nevertheless, be made in any case in which the gross income for the taxable year exceeds $624. If, for example, A has gross income for the taxable year of $850 and his wife B has gross income for the taxable year of $150, no return is required for normal tax and surtax purposes. However, since the gross income of A exceeds $624, a return is required for victory tax purposes. In such case A may file a separate return or A and B may under the provisions of section 51 (b) elect to make a joint return. See § 29.51-1 (b). In the case of a married person living with husband or wife if each spouse has more than $624 gross income for the taxable year, each must make a return unless they elect to make a joint return. If one such spouse has more than $624 gross income for the taxable year and the other spouse has less than $624 gross income for the taxable year, the spouse having more than $624 gross income may file a separate return or the spouses may elect to make a joint return for the taxable year.

In the case of a husband and wife living together, the election to make a joint return authorized under the provisions of section 51 (b) must be exercised with respect to the tax imposed under chapter 1 considered as a whole and not with respect to the several parts of such tax considered separately. Hence, a husband and wife living together may not elect to make separate returns for the purpose of the tax imposed by sections 11 and 12 or Supplement T and a joint return for the purpose of the victory tax. Likewise, such husband and wife may not elect to make separate returns for the purpose of the victory tax and joint returns for the purpose of the other parts of the tax imposed by chapter 1.

The status of a taxpayer making his return and paying his tax under Supplement T is determined under the provisions of section 401. Under those provisions a married person not the head of a family and not living with husband or wife on July 1 of the taxable year is treated as a single person. Hence, if married persons not living together on July 1 of the taxable year elect to pay the tax under Supplement T, each spouse is required to make a separate return. If such husband and wife are married and living together on July 1 of the taxable year, they may make either joint or separate returns under Supplement T. As to the making of returns generally, see section 51 and § 29.51-1. As to exclusions from gross income and the deductions therefrom for the purposes of the victory tax, see section 451 and § 29.451-1. As to credits against the victory tax, see section 453 and § 29.453-1.

(b) *Fiduciaries.* For taxable years beginning after December 31, 1942, every fiduciary and at least one of two or more joint fiduciaries must make a return for the purposes of the victory tax for any individual, estate, or trust for which he acts if the gross income (computed without regard to the exclusions from gross income provided in section 451 (a)) of such individual, estate, or trust is in excess of $624 for the taxable year. The return for victory tax purposes shall be made a part of the return of the estate or trust for normal tax and surtax purposes, if such return is required. The provisions of section 142 (a) and 142 (b) as well as section 455 (b) are applicable with respect to the return required for victory tax purposes. For form to be used in making the return under section 142 and section 455 (b), see § 29.142-1.

SEC. 456. LIMITATION ON TAX [as added by sec. 172 (a), Rev. Act 1942].

The tax imposed by section 450 (victory tax), computed without regard to the credits provided in sections 453, 454, and 466 (e), shall not exceed the excess of 90 per centum of the net income of the taxpayer for the taxable year over the tax imposed by sections 11 (normal tax) and 12 (surtax), computed without regard to the credits provided in sections 31, 32, and 466 (e).

§ 29.456-1. *Limitation on amount of the victory tax.* The amount of the victory tax, computed before the application thereto of any credit for the post war credit or refund or for the portion of the victory tax withheld at the source, cannot exceed an amount representing the excess of 90 percent of the taxpayer's net income for the taxable year over the sum of the normal tax and the surtax imposed for such taxable year by sections 11 and 12, respectively, computed before the application against such normal tax and surtax of (a) the credit for foreign income tax, (b) the credit for tax withheld at the source under section 143, and (c) the credit for victory tax withheld at the source under section 466. The application of this limitation may be illustrated by the following example:

Example. A, a married person having no dependents, has, for the calendar year 1943, a gross income of $2,000,000 and deductions (not allowable in computing victory tax net income) for interest, taxes, and contributions amounting to $200,000. His earned net income is $20,000. His wife had no gross income. His normal tax and surtax liability is computed as follows:

Gross income	$2,000,000
Less:	
Deductions	200,000
Net income	1,800,000
Less:	
Personal exemption	$1,200
Surtax net income	1,798,800
Less:	
Earned income credit (maximum)	1,400
Normal tax net income	1,797,400
Normal tax at 6 percent on $1,797,400	107,844
Surtax on $1,798,800	1,450,156
Total normal tax and surtax	1,558,000

The normal tax and surtax equal 86.56 percent of the net income. The 5 percent victory tax, if computed without any limitation on such tax, will amount to $99,968.80. Thus, the total normal tax, surtax, and victory tax would amount to $1,657,968.80, which would equal 92.11 percent of the net income. Therefore, the limitation will apply and the victory tax will be reduced to $62,000, making a total tax of $1,620,000, or 90 percent of the net income.

COLLECTION OF TAX AT SOURCE ON WAGES

SEC. 465. DEFINITIONS [as added by sec. 172 (a), Rev. Act 1942].

As used in this part[1]—

(a) *Pay-roll period.* The term "pay-roll period" means a period for which a payment of wages is ordinarily made to the employee by his employer.

(b) *Wages.* The terms "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid (1) for services performed as a member of the military or naval forces of the United States, other than pensions and retired pay, (2) for agricultural labor (as defined in section 1426 (h)), (3) for domestic service in a private home, local college club, or local chapter of a college fraternity or sorority, (4) for casual labor not in the course of the employer's trade or business, (5) for services as an employee of a nonresident alien individual, foreign partnership, or foreign corporation, if such individual, partnership, or corporation is not engaged in trade or business in the United States, (6) for services as an employee of a foreign government or any wholly owned instrumentality thereof, or (7) for services performed as an employee

[1] This part comprises sections 465 to 470, inclusive.

while outside the United States (as defined in section 3797 (a) (9)), unless the major part of the services performed during the calendar year by such employee for his employer are performed within the United States.

(c) *Withholding agent.* The term "withholding agent" means any person required to withhold, collect, and pay the tax under section 466.

(d) *Employee.* The term "employee" includes an officer, employee, or elected official of the United States, a State, Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

(e) *Employer.* The term "employer" includes any person for whom an individual performs any service, of whatever nature, as the employee of such person.

§ 29.465-0 *Introductory.* Sections 465 to 470, inclusive, provide for collection of tax at the source on wages. The regulations prescribed thereunder relate to the operation and effect of the provisions dealing with collection at the source and have no application in the determination of questions relating to the incidence or computation of the victory tax imposed under section 450. Hence, the fact that income of certain specified classes of individuals or income derived from certain specified sources is excluded from the definition of wages for the purpose of collection of tax at the source is not determinative of the question whether or not such income is subject to the victory tax. As to persons subject to the victory tax and the computation of victory tax net income, see §§ 29.451-1 and 29.451-2.

§ 29.465-1 *Pay-roll period.* The term "pay-roll period" means the period for which a payment of wages is ordinarily made to an employee by his employer. If the periods for which payments of wages are made to an employee by his employer are of uniform duration, each such period constitutes a pay-roll period. If, however, the periods occasionally vary in duration, the pay-roll period is the period for which a payment of wages is ordinarily made to the employee by his employer, even though that period does not coincide with the actual period for which a particular payment of wages is made. For example, if an employer ordinarily pays a particular employee for each calendar week at the end of the week, but the employee receives a payment in the middle of the week for the portion of the week already elapsed and receives the remainder at the end of the week, the pay-roll period is still the calendar week; or if, instead, that employee is sent on a trip by his employer and receives at the end of the week a single wage payment for three weeks' services, the pay-roll period is still the calendar week.

§ 29.465-2 *Wages*—(a) *In general.* The term "wages" means all remunerations for services performed by an employee for his employer unless specifically excepted under section 465 (b) or section 466 (g). (See §§ 29.465-3 and 29.466-6.)

The name by which the remuneration for services is designated is immaterial. Thus, salaries, fees, bonuses, commissions on sales or on insurance premiums, pensions, and retired pay are wages within the meaning of the statute if paid as compensation for services performed by the employee for his employer.

The basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages. Thus it may be paid on the basis of piecework, or a percentage of profits; and may be paid hourly, daily, weekly, monthly, or annually.

The medium in which the remuneration is paid is also immaterial. It may be paid in cash or in something other than cash, as, for example, stocks, bonds, or other forms of property. Remuneration paid in items other than cash shall be computed on the basis of the fair market value of such items at the time of payment.

Ordinarily, facilities or privileges (such as entertainment, medical services, or so-called "courtesy" discounts on purchases), furnished or offered by an employer to his employees generally, are not considered as remuneration for services if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees.

Tips or gratuities paid directly to an employee by a customer of an employer, and not accounted for by the employee to the employer, are not subject to withholding.

Remuneration for services, unless such remuneration is specifically excepted by the statute, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

Example. A is employed by B during the month of January 1943 and is entitled to receive remuneration of $100 for the services performed for B, the employer, during the month. A leaves the employ of B at the close of business on January 31, 1943. On February 15, 1943 (when A is no longer an employee of B), B pays A a remuneration of $100 which was earned for the services performed in January. The $100 is wages within the meaning of the statute.

(b) *Pensions and retired pay.* Pensions and retired pay are wages within the meaning of the statute. However, amounts receivable by an employee upon retirement which are taxed as annuities under the provisions of section 22 (b) (2) and distributions under an employees' trust taxable, because of the provisions of section 165 (b), as gain from the sale or exchange of a capital asset do not constitute wages subject to withholding. So-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and do not constitute wages.

(c) *Traveling and other expenses.* Amounts paid or reimbursements made to employees specifically for traveling or other expenses incurred in the business of the employer are not subject to withholding.

(d) *Vacation allowances.* Amounts of so-called "vacation allowances" paid to an employee constitute wages. Thus, the salary of an employee on vacation, paid notwithstanding his absence from work, constitutes wages.

(e) *Dismissal payments.* Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise, to make such payments.

(f) *Deductions by employer from wages of employee.* The amount of any tax which is required by law to be deducted by the employer from the wages of an employee is considered to be a part of the employee's wages and is deemed to be paid to the employee as wages at the time the deduction is made. Other amounts deducted from the wages of an employee by an employer also constitute wages paid to the employee at the time of the deduction. It is immaterial that the Internal Revenue Code, or any Act of Congress, or the law of any State, requires or permits such deductions and the payment of the amounts thereof to the United States, a State, a Territory, or the District of Columbia, or any political subdivision of any one or more of the foregoing.

(g) *Payment by an employer of employee's tax, or employee's contributions under a State law.* The term "wages" includes the amount of any payment made by an employer on behalf of an employee (without deduction from the remuneration of, or other reimbursements from, the employee) of any payment required from an employee under a State unemployment compensation law, or of any tax imposed upon the employee by any taxing authority, including the taxes imposed by sections 1400 and 1500.

§ 29.465-3 *Exclusions from wages*—(a) *Fees paid to a public official.* Authorized fees paid to public officials, such as notaries public, clerks of courts, sheriffs, etc., for services rendered in the performance of their official duties are excepted from the definition of the term "wages" and hence are not subject to withholding. However, salaries paid such officials by the Government, or Government agency or instrumentality, are subject to withholding.

(b) *Compensation of military and naval forces.* Remuneration paid for services performed as a member of the military or naval forces of the United States is excepted from the definition of the term "wages." For the purpose of the exception, the military and naval forces of the United States include (but are not necessarily limited to) the Army, the Navy, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Navy Nurse Corps, Female, the Women's Army Auxiliary Corps or the Women's Army Corps, the Women's Reserve Branch of the Naval Reserve, the Women's Reserve Branch of the Coast Guard Reserve, and the Marine Corps Women's Reserve.

(c) *Remuneration paid for agricultural labor*—(1) *In general.* The term "wages" does not include remuneration for services which constitute agricul-

tural labor as defined in section 1426 (h) of the Internal Revenue Code. The term "agricultural labor" as so defined includes services of a character described in subparagraphs (2), (3), (4), and (5) of this paragraph.

In general, however, the term "agricultural labor" does not include services performed in connection with forestry, lumbering, or landscaping.

(2) *Services described in section 1426 (h) (1).* Remuneration paid for services performed on a farm by an employee of any person in connection with any of the following activities is excepted as remuneration for agricultural labor:

(i) The cultivation of the soil;

(ii) The raising, shearing, feeding, caring for, training, or management of live stock, bees, poultry, fur-bearing animals, or wildlife; or

(iii) The raising or harvesting of any other agricultural or horticultural commodity.

The term "farm" as used in this and succeeding paragraphs of this subsection includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, orchards, and such greenhouses and other similar structures as are used primarily for the raising of agricultural or horticultural commodities. Greenhouses and other similar structures used primarily for other purposes (for example, display, storage, and fabrication of wreaths, corsages, and bouquets), do not constitute "farms."

(3) *Services described in section 1426 (h) (2).* The remuneration paid for the following services performed by an employee in the employ of the owner or tenant or other operator of one or more farms is excepted as remuneration for agricultural labor, provided the major part of such services is performed on a farm:

(i) Services performed in connection with the operation, management, conservation, improvement, or maintenance of any of such farms or its tools or equipment; or

(ii) Services performed in salvaging timber, or clearing land of brush and other debris, left by a hurricane.

The services described in (i) above may include, for example, services performed by carpenters, painters, mechanics, farm supervisors, irrigation engineers, bookkeepers, and other skilled or semiskilled workers, which contribute in any way to the conduct of the farm or farms, as such, operated by the person employing them, as distinguished from any other enterprise in which such person may be engaged.

Since the services described in this subparagraph (3) must be performed in the employ of the owner or tenant or other operator of the farm, the exception does not extend to remuneration paid for services performed by employees of a commercial painting concern, for example, which contracts with a farmer to renovate his farm properties.

(4) *Services described in section 1426 (h) (3).* Remuneration paid for services performed by an employee in the employ of any person in connection with any of the following operations is excepted as remuneration for agricultural labor without regard to the place where such services are performed:

(i) The ginning of cotton;

(ii) The hatching of poultry;

(iii) The raising or harvesting of mushrooms;

(iv) The operation or maintenance of ditches, canals, reservoirs, or waterways used exclusively for supplying or storing water for farming purposes;

(v) The production or harvesting of maple sap or the processing of maple sap into maple sirup or maple sugar (but not the subsequent blending or other processing of such sirup or sugar with other products); or

(vi) The production or harvesting of crude gum (oleoresin) from a living tree or the processing of such crude gum into gumspirits of turpentine and gum rosin, provided such processing is carried on by the original producer of such crude gum.

(5) *Services described in section 1426 (h) (4).* (i) Remuneration paid for services performed by an employee in the employ of a farmer or a farmers' cooperative organization or group in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of any agricultural or horticultural commodity, other than fruits and vegetables (see subdivision (ii) below), produced by such farmer or farmer-members of such organization or group of farmers is excepted, provided such services are performed as an incident to ordinary farming operations.

Generally services are performed "as an incident to ordinary farming operations" within the meaning of this subparagraph (5) if they are services of the character ordinarily performed by the employees of a farmer or of a farmers' cooperative organization or group as a prerequisite to the marketing, in its unmanufactured state, of any agricultural or horticultural commodity produced by such farmer or by the members of such farmers' organization or group. Services performed by employees of such farmer or farmers' organization or group in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of commodities produced by persons other than such farmer or members of such farmers' organization or group are not performed "as an incident to ordinary farming operations."

(ii) Remuneration paid for services performed by an employee in the employ of any person in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of fruits and vegetables, whether or not of a perishable nature, is excepted as remuneration for agricultural labor, provided such services are performed as an incident to the preparation of such fruits and vegetables for market. For example, if services in the sorting, grading, or storing of fruits, or in the cleaning of beans, are performed as an incident to their preparation for market, remuneration paid for such services may be excepted whether the services are performed in the employ of a farmer, a farmers' cooperative, or a commercial handler of such commodities.

(iii) The services described in subdivisions (i) and (ii), above, do not include services performed in connection with commercial canning or commercial freezing, or in connection with any commodity after its delivery to a terminal market for distribution for consumption. Moreover, since the services described in such subdivisions must be rendered in the actual handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of the commodity, such services do not, for example, include services performed as stenographers, bookkeepers, clerks, and other office employees, even though such services may be in connection with such activities. However, to the extent that the services of such individuals are performed in the employ of the owner or tenant or other operator of a farm and are rendered in major part on a farm, they may be within the provisions of subparagraph (3) of this paragraph.

(d) *Remuneration paid for domestic service.* Remuneration paid for services of a household nature performed by an employee in or about the private home of the person by whom he is employed, or performed in or about the clubrooms or house of a local college club or local chapter of a college fraternity or sorority by which he is employed, is excepted from the term "wages."

A private home is the fixed place of abode of an individual or family.

A local college club or local chapter of a college fraternity or sorority does not include an alumni club or chapter.

If the home is utilized primarily for the purpose of supplying board or lodging to the public as a business enterprise, it ceases to be a private home and the remuneration paid for services performed therein is not excepted. Likewise, if the clubrooms or house of a local college club or local chapter of a college fraternity or sorority is used primarily for such purpose, the remuneration paid for services performed therein is not within the exception.

In general, services of a household nature in or about a private home include services rendered by cooks, maids, butlers, valets, laundresses, furnacemen, gardeners, footmen, grooms, and chauffeurs of automobiles for family use. In general, services of a household nature in or about the clubrooms or house of a local college club or local chapter of a college fraternity or sorority include services rendered by cooks, maids, butlers, laundresses, furnacemen, waiters, and housemothers.

The remuneration paid for the services above enumerated is not within the exception if performed in or about rooming or lodging houses, boarding houses, clubs (except local college clubs), hotels, hos-

pitals, eleemosynary institutions, or commercial offices or establishments.

Remuneration paid for services performed as a private secretary, even though performed in the employer's home, is not within the exception.

(e) *Remuneration for casual labor not in the course of employer's trade or business.* The term "casual labor" includes labor which is occasional, incidental, or irregular.

The expression "not in the course of the employer's trade or business" includes labor that does not promote or advance the trade or business of the employer.

Thus remuneration paid for labor which is occasional, incidental, or irregular, and does not promote or advance the employer's trade or business, is excepted.

Example. A's business is that of operating a sawmill. He employs B, a carpenter, at an hourly wage to repair his home. B works irregularly and spends the greater part of two days in completing the work. Since B's labor is casual and is not in the course of A's trade or business, the remuneration paid for such services is excepted.

The remuneration paid for casual labor, that is, labor which is occasional, incidental, or irregular, but which is in the course of the employer's trade or business, does not come within the above exception.

Example (1). C's business is that of operating a sawmill. He employs D for two hours, at an hourly wage, to remove sawdust from his mill. D's labor is casual since it is occasional, incidental, or irregular, but it is in the course of C's trade or business and the remuneration paid for such labor is not excepted.

Example (2). E is engaged in the business of operating a department store. He employs additional clerks for short periods. While the services of the clerks may be casual, they are in the course of the employer's trade or business and, therefore, the remuneration paid for such services is not excepted.

Remuneration paid for casual labor performed for a corporation does not come within this exception.

(f) *Compensation paid by nonresident alien individual, foreign partnership, or foreign corporation.* Remuneration paid for services performed as an employee of a nonresident alien individual, foreign partnership, or foreign corporation, if such individual, partnership, or corporation is not engaged in trade or business in the United States, is excepted. The exception has no application if the employer paying such remuneration is engaged in trade or business in the United States. Whether or not a nonresident alien individual, foreign partnership, or foreign corporation is engaged in trade or business within the United States depends upon the particular facts of each case and will be determined in accordance with the rules applicable under sections 211, 219, and 231 for income tax purposes generally.

For purposes of this exception, the citizenship or residence of the employee or the place where the services are performed is immaterial.

(g) *Compensation paid by foreign government or wholly-owned instrumentality thereof.* Remuneration paid for services performed as an employee of a foreign government or wholly-owned instrumentality thereof is excepted. The exception includes not only remuneration paid for services performed by ambassadors, ministers, and other diplomatic officers and employees but also remuneration paid for services performed as a consular or other officer or employee of a foreign government, or as a diplomatic representative of such a government.

The citizenship or residence of the employee and the place where the services are performed are immaterial for purposes of the exception.

(h) *Remuneration for services performed outside the United States.* The remuneration paid by an employer for services performed outside the United States does not constitute wages and hence is not subject to withholding unless the major part of the services performed by the employee for such employer during the calendar year is performed within the United States. The term "United States" includes the several States, the Territories of Alaska and Hawaii, and the District of Columbia.

The exception relates only to the remuneration paid for the services performed outside the United States regardless of whether the major part of the services performed for such employer during the calendar year is performed within or without the United States. Thus, if an employee performs services outside the United States for more than six months of the calendar year, the remuneration paid for such services does not constitute wages and hence is not subject to withholding; but the remuneration paid for services performed within the United States for such employer during the remainder of the calendar year constitutes wages and is subject to withholding.

If, however, an employee is absent from the United States on business of his employer for less than six months of the calendar year and performs services for such employer within the United States during the remainder of the calendar year, the entire amount of the remuneration paid for services performed during the calendar year constitutes wages and is subject to withholding.

However, it is recognized that in the case of an employee performing, outside the United States, services of indefinite duration, it may be impossible for the employer to determine whether the major portion of the employee's services during the calendar year will be performed within the United States or outside the United States. In such case it may be presumed that such performance will continue throughout the calendar year and the liability of the employer to withhold tax on the compensation paid for such services performed outside the United States will be determined in the light of such presumption. Thus, if an employee undertakes for his employer the performance of services abroad of indefinite duration, or for a term extending beyond the end of the calendar year, and such employee has not already within the calendar year, performed services within the United States for a length of time which would constitute, in any circumstances, the major part of the year's services for such employer, no tax is required to be withheld on the compensation paid for services performed by such employee outside the United States.

Example (1). A has been regularly employed by B, and is sent abroad under such conditions that it is not possible to know when he will return: (a) If A goes abroad on January 1, no tax is required to be withheld on compensation paid to A for services performed abroad, but on the compensation paid for services performed after his return to the United States tax should be withheld. (b) If A goes abroad on June 29, the same rules are applicable. No tax is required to be withheld on the compensation for services performed abroad but on compensation for services performed after his return to the United States tax should be withheld. (c) If A goes abroad on August 1, tax should be withheld on the compensation paid A for all services performed during the calendar year since under no circumstances could the major part of the services performed during such year be performed outside the United States.

Example (2). A begins his employment with B on July 1, and on September 1 is sent abroad under the circumstances described in example (1). No tax is required to be withheld on the compensation paid A for the services performed abroad.

Example (3). A begins his employment with B on July 1, and on November 1 is sent abroad under the circumstances described in example (1). Tax is required to be withheld on the compensation paid A for the services performed abroad, as well as on compensation paid for service performed within the United States, for the reasons set forth in example (1) (c).

The presumption that employees performing services of indefinite duration outside the United States will continue to perform such services throughout the calendar year does not apply in the case of employees sent abroad during the year on business missions of limited duration when there is reasonable expectation that the employee can and will return at such time that the major portion of his services for the employer for that calendar year will be performed within the United States.

§ 29.465-4 *Withholding agent.* Any person required to withhold, collect, and pay the tax imposed by section 466 is a withholding agent. Under section 467 (a), the tax required to be withheld shall be collected by the person having control of the payment of wages. In the case of private employers, the employer is the withholding agent. In situations where neither the wage payment nor the funds from which payment is made is subject to the control of the employer, the person having such control is the withholding agent. For example, where wages such as pensions or retired pay are paid through the medium of a trust over which the employer has no control, the trustee is the withholding agent. With respect to public employees, the withholding agent is by presumption the head officer of particular offices approving and scheduling pay rolls for payment, or, where some other form of administrative procedure for the payment of wages is in effect, the officer exercising control through such procedure.

§ 29.465-5 *Employee.* The term "employee" includes every individual per-

forming services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. The term specifically includes officers and employees, whether elected or appointed, of the United States, a State, Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor. An individual performing services as an independent contractor is not as to such services an employee.

Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are independent contractors and not employees.

Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case.

If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, or independent contractor.

The measurement, method, or designation of compensation is also immaterial, if the relationship of employer and employee in fact exists.

No distinction is made between classes or grades of employees. Thus, superintendents, managers, and other superior employees are employees. An officer of a corporation is an employee of the corporation but a director as such is not. A director may be an employee of the corporation, however, if he performs services for the corporation other than those required by attendance at and participation in meetings of the board of directors.

Although an individual may be an employee under the statute, his services may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 465 (b). (See § 29.465-3.)

§ 29.465-6 *Employer.* The term "employer" includes any person for whom an individual performs any service, of whatever nature, as the employee of such person. An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

The term "employer" embraces not only individuals and organizations engaged in trade or business, but organizations exempt from income tax, such as religious and charitable organizations, educational institutions, clubs, social organizations and societies, as well as the governments of the United States, the States, Territories, and the District of Columbia, including their agencies, instrumentalities, and political subdivisions.

Although a person may be an employer under the statute, services performed in his employ may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 465 (b). (See § 29.465-3.)

SEC. 466. TAX COLLECTED AT SOURCE [as added by sec. 172 (a), Rev. Act 1942].

(a) *Requirement of withholding.* There shall be withheld, collected, and paid upon all wages of every person, to the extent that such wages are includible in gross income, a tax equal to 5 per centum of the excess of each payment of such wages over the withholding deduction allowable under this part.[1] This subsection and subsection (c) shall not be applicable in any case provided for in section 143, except in the case of wages paid to residents of a contiguous country who enter and leave the United States at frequent intervals.

(b) *Withholding deduction.* (1) In computing the tax required to be withheld under subsection (a), there shall be allowed as a deduction against the wages paid for each pay-roll period an amount determined in accordance with the following schedule:

Pay-roll period	*Withholding deduction*
Weekly	$12
Biweekly	24
Semimonthly	26
Monthly	52
Quarterly	156
Semiannually	312
Annually	624

[1] This part comprises sections 465 to 470, inclusive.

(2) If a pay-roll period in respect of any wages is less than one week, the excess of the aggregate of the wages paid during each calendar week over the deduction allowed by this subsection for a weekly pay-roll period shall be used in computing the tax required to be withheld.

(3) If a pay-roll period in respect of any wages, or any other period with respect to which wages are paid, is not otherwise specifically provided for in this subsection, the deduction allowable against each payment of such wages shall be the deduction allowable in the case of an annual pay-roll period divided by 365 and multiplied by the number of days in such period, including Sundays and holidays.

(4) In any case in which wages are paid by an employer without regard to any pay-roll period or other period, the deduction allowable against each payment of such wages shall be the deduction allowable in the case of an annual pay-roll period divided by 365 and multiplied by the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(5) The deduction allowable under this subsection in respect of any individual for any calendar year shall not exceed the total deduction which would have been allowable under paragraph (1) if the the only pay-roll period of such individual had been an annual pay-roll period.

(c) *Wage bracket withholding.* (1) At the election of the employer, if his pay-roll period with respect to an employee is weekly, biweekly, semimonthly, or monthly, there shall be withheld, collected, and paid upon the wages of such employee a tax determined in accordance with the following tables, which shall be in lieu of the tax required to be withheld under subsection (a):

For weekly pay-roll period			For biweekly pay-roll period		
If the wages are over—	But not over—	The amount of tax to be withheld shall be—	If the wages are over—	But not over—	The amount of tax to be withheld shall be—
$12	$16	$0.10	$24	$30	$0.10
16	20	.30	30	40	.50
20	24	.50	40	50	1.00
24	28	.70	50	60	1.50
28	32	.90	60	70	2.00
32	36	1.10	70	80	2.50
36	40	1.30	80	100	3.30
40	50	1.60	100	120	4.30
50	60	2.10	120	140	5.30
60	70	2.60	140	160	6.30
70	80	3.10	160	180	7.30
80	90	3.60	180	200	8.30
90	100	4.10	200	220	9.30
100	110	4.60	220	240	10.30
110	120	5.10	240	260	11.30
120	130	5.60	260	280	12.30
130	140	6.10	280	300	13.30
140	150	6.60	300	320	14.30
150	160	7.10	320	340	15.30
160	170	7.60	340	360	16.30
170	180	8.10	360	380	17.30
180	190	8.60	380	400	18.30
190	200	9.10	400	420	19.30
200	--------	(1)	420	440	20.30
			440	460	21.30
			460	480	22.30
			480	500	23.30
			500	--------	(2)

[1] $9.40 plus 5% of the excess over $200.
[2] $23.80 plus 5% of the excess over $500.

For semimonthly pay-roll period			For monthly pay-roll period		
If the wages are over	But not over	The amount of tax to be withheld shall be—	If the wages are over	But not over	The amount of tax to be withheld shall be—
$26	$30	$0.10	$52	$60	$0.20
30	40	.40	60	80	.80
40	50	.90	80	100	1.80
50	60	1.40	100	120	2.80
60	70	1.90	120	140	3.80
70	80	2.40	140	160	4.80
80	100	3.20	160	200	6.40
100	120	4.20	200	240	8.40
120	140	5.20	240	280	10.40
140	160	6.20	280	320	12.40
160	180	7.20	320	360	14.40
180	200	8.20	360	400	16.40
200	220	9.20	400	440	18.40
220	240	10.20	440	480	20.40
240	260	11.20	480	520	22.40
260	280	12.20	520	560	24.40
280	300	13.20	560	600	26.40
300	320	14.20	600	640	28.40
320	340	15.20	640	680	30.40
340	360	16.20	680	720	32.40
360	380	17.20	720	760	34.40
380	400	18.20	760	800	36.40
400	420	19.20	800	840	38.40
420	440	20.20	840	880	40.40
440	460	21.20	880	920	42.40
460	480	22.20	920	960	44.40
480	500	23.20	960	1,000	46.40
500		[3]	1,000		[4]

[3] $23.70 plus 5% of the excess over $500.
[4] $47.40 plus 5% of the excess over $1,000.

(d) *Tax paid by recipient.* If any tax required under this part[1] to be withheld and collected is paid by the recipient of the income, it shall not be re-collected from the withholding agent; but such payment shall in no case relieve the withholding agent from liability for interest or additions to the tax otherwise applicable in respect of the tax imposed by this chapter.

(e) *Credit for tax withheld at source.* The tax withheld and collected under this part[1] shall not be allowed as a deduction either to the withholding agent or to the recipient of the income in computing net income; but the amount of the tax so withheld and collected shall be allowed as a credit against the tax imposed by this chapter upon the recipient of the income. Such credit shall be allowed first against the victory tax imposed by section 450 (adjusted for the credit allowed by section 453) and the excess of such credit, if any, over the victory tax, so adjusted, shall be allowed against the tax imposed by sections 11 and 12 or section 400, as the case may be.

(f) *Refunds.* Where there has been an overpayment of tax under this part,[1] any refund or credit made under the provisions of section 322 shall be made to the recipient of the income; but, in any case in which such tax was not so withheld by the withholding agent, such refund or credit shall be made to the withholding agent.

(g) *Included and excluded wages.* If the remuneration paid by an employer to an employee for services performed during one-half or more of any pay-roll period constitutes wages, all the remuneration paid by such employer to such employee for such period shall be deemed to be wages; but if the remuneration paid by an employer to an employee for services performed during more than one-half of any such pay-roll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed to be wages.

[1] This part comprises sections 465 to 470, inclusive.

§ 29.466-1 *Requirement of withholding—(a) In general.* Subject to certain prescribed conditions, section 466 provides, at the election of the employer, alternative methods for computing the tax with respect to wages includible in gross income: (1) A tax equal to 5 percent of the excess of each payment of such wages over the withholding deduction (hereinafter referred to as withholding exemption) allowable under section 466 (b), or (2) a tax determined in accordance with the tables provided in section 466 (c). See § 29.466 (c). The tax is applicable to all wages actually or constructively paid on or after January 1, 1943, regardless of the period for which paid or the method of accounting followed by the employee in computing his income for tax purposes, and is collected by deducting the amount thereof from such wages as and when so paid.

Example (1). Employer X has a semimonthly pay-roll period ending on the 10th and 25th days of the month. The wages earned during such periods are customarily paid on the 15th and 30th days of the month, respectively. The wages earned during the semimonthly period ending on January 10, 1943, and paid on January 15, 1943, are subject to withholding when paid.

Example (2). Employer Y has a weekly pay-roll period based on the calendar week and the wages earned during each calendar week are customarily paid on Wednesday of the succeeding week. The wages earned during the week ending January 2, 1943, and paid on Wednesday, January 6, 1943, are subject to withholding when paid.

Wages are constructively paid within the meaning of this section when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited or set apart to the employee 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 they may be drawn upon at any time, and their payment brought within his control and disposition.

(b) *Wages includible in gross income.* Under the provisions of section 466, wages are subject to withholding only if and to the extent includible in gross income. The term "includible in gross income" as it relates to wages from which the tax is required to be deducted and withheld refers only to the taxability of the income. Thus, if an item of wages constitutes gross income under the provisions of section 22, it is includible in gross income within the meaning of this section and is subject to withholding. The fact that such wages may be includible in gross income for a taxable year other than that in which paid is immaterial. For instance, in the case of a taxpayer on the accrual basis, wages actually or constructively paid in 1944 but includible in the recipient's gross income for 1943 are subject to withholding in 1944. Likewise, the fact that wages may be includible in the gross income of a taxpayer other than the wage earner is immaterial. For instance, a part of the wages earned by a taxpayer domiciled in a community property State may be includible for tax purposes in the gross income of his spouse. Nevertheless, the entire amount paid to the wage earner should be taken into account in computing the amount of the tax to be withheld at source.

(c) *Nonresident aliens.* Nonresident alien individuals are not subject to withholding under the victory tax provisions, except that such nonresident aliens who are residents of Canada or Mexico and who enter and leave the United States at frequent intervals are subject to the victory tax withholding provisions upon wages paid for services performed within the United States.

§ 29.466-2 *Withholding exemption—(a) In general.* In computing the amount of the tax to be withheld from wage payments, a withholding exemption is allowable against the wages paid by each employer for each pay-roll period based upon an annual exemption of $624 prorated in accordance with the length of the particular pay-roll period. Under the schedule provided in section 466 (b) (1), the amount of the exemption is as follows:

Pay-roll period:	Withholding exemption
Weekly	$12.00
Biweekly	24.00
Semimonthly	26.00
Monthly	52.00
Quarterly	156.00
Semiannually	312.00
Annually	624.00

The amount of the exemption in respect of the wages paid a particular employee is determined by reference to such employee's pay-roll period and without regard to the time the employee is actually engaged in the performance of services during such period.

Example (1). Employer X has a semimonthly pay-roll period. An employee whose wages are determined on an hourly rate basis works 20 hours and earns $24 during the pay-roll period. The amount of the withholding exemption allowable in respect of such wages is $26.

Example (2). Employer Y has a weekly pay-roll period. An employee paid at the rate of $10 per day worked two days and resigned. The amount of the withholding exemption allowable in respect of such wages paid such employee for the weekly period is $12.

(b) *Pay-roll period less than one week.* If the pay-roll period is less than one week, as in the case where employees are paid daily, the amount of tax withheld will be based upon the excess of the aggregate of the wages paid during the period of a calendar week over the exemption which would be allowed for a weekly pay-roll period. For instance, if an employee is paid daily at the rate of $5 per day, no tax shall be withheld with respect to the wages paid for the first two days of employment in the week. The wages paid for the third day will be subject to withholding on $3, the excess of the total wages for three days

($15) over the weekly exemption ($12). Subsequent wage payments during the same calendar week would be subject to withholding at the rate of 5 percent on the entire amount of each payment. During the following and subsequent weeks, the same procedure would apply. In the case of temporary or extra employees, if wages are paid at intervals of less than one week, the withholding exemption with respect to wages paid during any calendar week may be computed in accordance with the provisions of this subsection. As used herein, the term "calendar week" means a period of seven consecutive days beginning with Sunday and ending with Saturday.

(c) *Other pay-roll periods.* If the pay-roll period is greater than one week, and is a period not covered by the schedule set forth in section 466 (b), or if wages are paid for a period of more than one week which does not constitute a pay-roll period, the withholding exemption allowable with respect to each such payment of wages is determined by dividing the annual withholding exemption of $624 by 365 ($1.71) and multiplying by the number of days in the period, including Sundays and holidays. Thus, the withholding exemption allowable for a pay-roll period of 10 days is $17.10.

(d) *Wages paid without regard to any period.* In the case of wages paid without regard to any particular period, as, for instance, commissions paid to a salesman upon completion of a sale, the withholding exemption is measured by the number of days elapsed since the date of the last payment of wages to such employee by such employer during the calendar year, or the date on which employment with such employer began during the calendar year, or January 1 of such calendar year, whichever is the later.

Example. On April 1, 1943, A, an individual, was employed by the X Real Estate Co. to sell real estate on a commission basis, commissions to be paid only upon consummation of sales. On May 20, 1943, A received a commission of $300. Again, on June 15, 1943, A received a commission of $400. The amount of the withholding exemption allowable in respect of the commission paid on May 20 is ($1.71×50) $85.50; and the withholding exemption allowable with respect to the commission paid on June 15 is ($1.71×26) $44.46.

(e) *Maximum withholding exemption.* Under section 466 (b) (5) the total withholding exemption allowable to any individual with respect to wages received from any one employer during a calendar year shall not exceed the amount which would have been allowable if such individual had had an annual pay-roll period. Thus, the maximum amount of the exemption allowable with respect to wages paid to an employee by any one employer during a calendar year is $624.

If the amount of the exemption allowable with respect to wages paid for any period of one week or more exceeds the amount of wages paid with respect to such period, the unused portion of the exemption allowable with respect to such period may not be carried over to a subsequent period. Thus, if an employee's wages for a semimonthly pay-roll period are less than $26, the difference between such wages and the $26 exemption allowable with respect to such pay-roll period may not be carried forward to the subsequent pay-roll period.

(f) *Bonuses and commissions.* If an employee's remuneration for each pay-roll period consists of wages computed at a specified rate plus additional wages in the form of bonuses or commissions, the aggregate of the wages paid for each such period shall be considered as a single wage payment and only one withholding exemption shall be allowed with respect to such wages.

Example (1). A is employed as a salesman at a monthly salary of $100 plus commissions on sales made during the month. A withholding exemption of $52 is allowable against the aggregate wages, consisting of salary and commissions, considered as a single wage payment.

Example (2). B is employed as a mechanic at a specified rate per hour plus a bonus on production in excess of a fixed standard. Under the employer's pay-roll practice, wages are paid weekly and each wage payment consists of the wages for the current week computed at the regular rate plus the production bonuses earned during the preceding week. A withholding exemption of $12 is allowable against each such wage payment.

If an employee's compensation consists of wages paid with respect to a particular pay-roll period and in addition thereto bonuses or commissions paid with respect to a different period or without regard to any particular period, the amount of the withholding exemption allowable with respect to such wage payments shall, at the option of the employer, be determined in accordance with either of the following methods:

(1) The amount of the withholding exemption allowable with respect to the regular wage payment and the amount allowable with respect to the bonuses or commissions may be determined independently under the rules applicable to each. Thus, if a person receives a weekly salary for a 26-week period and at the end of such period receives a bonus paid with respect to the 6-month period, a withholding exemption of $12 is allowable in respect to each weekly wage payment, or an aggregate of $312 for the 26-week period, and a withholding exemption of $312 is allowable with respect to the bonus paid for the 6-month period. Since the aggregate of the withholding exemptions allowable with respect to the weekly wage and the bonus equals the maximum allowance of $624 for the calendar year in the case of such individual, no withholding exemption is allowable with respect to any further wages paid to such employee by the same employer during the calendar year; or

(2) The withholding exemption may be determined as if the aggregate of the additional wages and the regular wages constituted a single wage payment for the regular pay-roll period. For example, an employee is paid a monthly salary of $50 plus a bonus and commissions determined at the end of each 3-month period. The bonus and commission for a particular 3-month period amount to $375 which together with his regular monthly salary of $50 make a total of $425. The amount of the withholding exemption allowable with respect to the aggregate wages of $425 is $52.

§ 29.466-3 *Wage bracket withholding.* The use of the tables provided in section 466 (c) is optional with the employer. An employer may elect to use the wage bracket tables for determining the amount of the tax to be withheld in the case of any one or more of his employees provided only that such employees are paid on a weekly, biweekly, semimonthly, or monthly basis. For example, an employer may elect to use the optional method in case of one group of employees on a particular pay roll and at the same time may use the exact 5 percent method provided in section 466 (a) in the case of another group of employees on a different pay roll.

In order to determine the amount of the tax to be withheld with respect to any wage payment, the employer merely refers to the table applicable to the particular pay-roll period. For example, an employee's earnings for a weekly pay-roll period amount to $35. By reference to the table applicable to a weekly pay-roll period, it will be found that the $35 wage payment falls within the wage bracket from $32 to $36 and the amount of the tax to be withheld shown opposite such bracket is $1.10.

If an employer elects in the case of any employee to determine the tax under the wage bracket tables and such employee is paid in addition to his regular wages extra compensation in the form of bonuses, commissions, etc., no withholding exemption under section 466 (b) is allowable for the purpose of computing the amount of the tax to be withheld upon such additional compensation. In any such case, the amount of the tax to be withheld shall be determined in accordance with the following rules:

(a) If the employee's compensation for each pay-roll period consists of the regular wages plus such additional wages, the aggregate of the wages paid for each pay-roll period shall be considered as a single wage payment for the purpose of determining the appropriate wage bracket and the amount of the tax to be withheld under the table. For example, a salesman employed at a monthly salary of $100 plus commissions on sales made during each month received for a particular month, in addition to his regular salary, commissions amounting to $160. By reference to the table applicable to a monthly pay-roll period, it will be found that the $260 wage payment falls within the wage bracket from $240 to $280 and the amount of the tax to be withheld shown opposite such bracket is $10.40.

(b) If the employee's compensation consists of wages paid with respect to a particular pay-roll period and additional wages in the form of bonuses, commissions, etc., paid with respect to a different period or without regard to any particular period, the amount of the tax to be withheld may, at the option of the employer, be determined by either of the following methods: (1) The amount of the tax to be withheld on the regular wages shall be determined under the ap-

propriate wage table, and the amount of the tax to be withheld on the additional wages shall be 5 percent of each such wage payment, or (2) the aggregate of the additional wages and the regular wages shall be considered as a single wage payment and the amount of the tax to be withheld shall be determined under the table applicable to the regular pay-roll period. For example, an employee is paid a weekly salary of $65 plus a bonus determined at the end of each 3-month period. For a particular 3-month period, the employee is paid a bonus of $115. Under the method provided in (1), the amount of the tax to be withheld on the weekly wages as shown on the table provided for a weekly pay-roll period is $2.60, and the amount of the tax to be withheld on the bonus is 5 percent of $115, or $5.75. Under the method provided in (2), the amount of the tax to be withheld on the aggregate wage payment of $180 under the tablt applicable to a weekly pay-roll period is $8.10.

If, in the case of an employee, the wage bracket tables for determining the amount of the tax to be withheld are used for only a portion of the calendar year, and the exact 5 percent method is used for the balance of the calendar year, the maximum withholding exemption allowable with respect to the wages paid by such employer to such employee during the portion of the calendar year following such change shall not exceed an amount equal to the product of the withholding exemption applicable with respect to such employee's pay-roll period multiplied by the number of such periods in the remaining portion of the calendar year.

Example. In the case of certain employees having a weekly pay-roll period ending on Thursday of each week, an employer used the wage bracket tables for determining the tax to be withheld during the first quarter of the calendar year 1943. For the pay-roll period ending on Thursday, April 1, 1943, and for subsequent pay-roll periods during the calendar year 1943, the employer used the exact 5 percent method for computing the amount of the tax to be withheld. The maximum amount of the withholding exemption allowable with respect to the wages paid each employee during the balance of the calendar year is $12 (the withholding exemption applicable to a weekly pay-roll period) multiplied by 40 (the number of weekly pay-roll periods remaining in the calendar year), or $480.

§ 29.466-4 *Tax paid by recipient.* Section 466 (d) provides that if the tax required to be withheld, collected, and paid by the withholding agent is paid by the recipient of the income, it shall not be re-collected from the withholding agent. Such payment does not, however, operate to relieve the withholding agent from liability for interest or additions to the tax imposed for failure to withhold, collect, and pay, the tax within the time prescribed by law or regulations made in pursuance of law. Interest and additions to the tax shall be computed from the date prescribed in section 468 for the making of the return and payment of the tax by the withholding agent to the date of payment of the tax by the recipient of the income. In general, for interest and additions to tax for failure to make return or pay the tax within the time prescribed by law, see sections 291 to 299, inclusive. For minimum addition to tax for failure to make return within the time prescribed by law, see section 470 (c).

§ 29.466-5 *Return of income and credit for tax withheld at source.* The entire amount of the wages from which the tax is withheld shall be included in gross income in the return required to be made by the recipient of the income without deductions for such tax. The tax withheld at source, however, is allowable as a credit against the victory tax imposed upon the recipient of the income and any excess thereof over the amount of the victory tax is allowable as a credit against the tax imposed by sections 11 and 12 or the tax imposed by section 400, as the case may be. Any excess of the tax withheld at source over the aggregate of the tax imposed by chapter 1 shall be refunded to the recipient of the income. If the tax has actually been withheld and collected at the source, refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the withholding agent. See section 322. For the purpose of the credit, the recipient of the income is the person subject to the tax imposed under chapter 1 upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a community property State 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.

Example. A and B are married and living together and have two dependent children throughout the calendar year 1943. Their joint return for 1943 discloses normal tax of $1,075.02, surtax of $6,605.33, and victory tax (before allowance of the credit provided in section 453) of $993.80. A credit under the provisions of section 453 is claimed on account of premiums paid in the amount of $628 on life insurance in force on September 1, 1942, and the purchase of war savings bonds during the calendar year 1943 at a cost of $1,200. The victory tax withheld at the source from the wages of A amounts to $968.80. The tax liability of A and B for the calendar year 1943 is shown as follows:

Item			
Victory tax (gross)			$993.80
Credit claimed under section 453 (not to exceed post war credit):			
1. Premiums paid on life insurance	$628.00		
2. Purchase of war bonds	1,200.00		
Total	1,828.00		
Post war credit: 44 percent of $993.80, or $1,200, whichever is the lesser		$437.27	
Credit allowable under section 453			$437.27
Victory tax (net)			556.53
Less: Credit for tax withheld at source			968.80
Excess credit (allowable against other income tax)			412.27
Income tax:			
Normal tax			1,075.02
Surtax			6,605.33
Total			7,680.35
Less: Balance of credit for tax withheld at source			$412.27
Income tax payable			7,268.08

§ 29.466-6 *Included and excluded wages.* If a portion of the remuneration paid by an employer to his employee for services performed during a pay-roll period constitutes wages, and the remainder does not constitute wages, all the remuneration paid the employee for services performed during such period shall for purposes of withholding be treated alike, that is, either all included as wages or all excluded. The time during which the employee performs services, the remuneration for which under section 465 (b) constitutes wages, and the time during which he performs services, the remuneration for which under such section does not constitute wages, determine whether all the remuneration for services performed during the pay-roll period shall be deemed to be included or excluded.

If one-half or more of the employee's time in the employ of a particular person in a pay-roll period is spent in performing services the remuneration for which constitutes wages, then all the wages paid the employee for services performed in that pay-roll period shall be deemed to be wages.

If less than one-half of the employee's time in the employ of a particular person in a pay-roll period is spent in performing services the remuneration for which constitutes wages, then none of the wages paid the employee for services performed in that pay-roll period shall be deemed to be wages.

Example (1). Employee A is employed by B who operates a farm and a store. The remuneration paid A for services on the farm is excepted as remuneration for agricultural labor, and the remuneration for services performed in the store constitutes wages. Employee A is paid on a monthly basis. During a particular month, A works 120 hours on the farm and 80 hours in the store. None of the remuneration paid A for services performed during the month is deemed to be wages, since the remuneration paid for less than one-half of the services performed during the month constitutes wages.

During another month A works 75 hours on the farm and 120 hours in the store. All of the remuneration paid A for services performed during the month is deemed to be wages since the remuneration paid for one half or more of the services performed during the month constitutes wages.

Example (2). Employee C is employed as a maid by D, a physician, whose home and office are located in the same building. The remuneration paid C for services in the home is excepted as remuneration for domestic service, and the remuneration paid for her services in the office constitutes wages. C is paid on a weekly basis. During a particular week C works 20 hours in the home and 20 hours in the office. All of the remuneration paid C for services performed during that week is deemed to be wages, since the remuneration paid for one-half or more of the services performed during the week constitutes wages.

During another week C works 22 hours in the home and 15 hours in the office. None of the remuneration paid C for services performed during that week is deemed to be wages, since the remuneration paid for more than one-half of the services performed during the week does not constitute wages.

The rules set forth in this section do not apply with respect to any remuneration paid for services performed by an employee for his employer if the periods for which remuneration is paid by the employer vary to the extent that there is no period which constitutes a pay-roll period within the meaning of section 465 (a). In such a case withholding is required with respect to that portion of such remuneration which constitutes wages.

SEC. 467. WITHHOLDING AGENT [as added by sec. 172 (a), Rev. Act 1942].

(a) *Collection of tax.* The tax required to be withheld by section 466 shall be collected by the person having control of the payment of such wages by deducting such amount from such wages as and when paid. As used in this subsection, the term "person" includes officers and employees of the United States, or of a State, Territory, or any political subdivision thereof, or of the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

(b) *Indemnification of withholding agent.* Every person required to withhold and collect any tax under this part shall be liable for the payment of such tax, and shall not be liable to any person for the amount of any such payment.

(c) *Adjustments.* If more or less than the correct amount of tax is withheld or paid for any quarter in any calendar year, proper adjustments, with respect both to the tax withheld or the tax paid, may be made in any subsequent quarter of such calendar year, without interest, in such manner and at such times as may be prescribed by regulations made by the Commissioner, with the approval of the Secretary.

§ 29.467-1 *Collection of and liability for tax.* Under the provisions of section 467, the withholding agent is required to collect the tax by deducting the amount thereof from the employee's wages as and when paid, either actually or constructively. The withholding agent is required to collect the tax notwithstanding the wages are paid in something other than money (for example, wages paid in stock or bonds; see § 29.465-2) and to pay the tax to the collector in money. If wages are paid in property other than money, necessary arrangements should be made between the employer and employee to insure that the amount of the tax is available for payment to the collector.

Every person required to withhold and collect the tax under section 466 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee. If, for example, an employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. See, however, section 466 (d), relieving the withholding agent from liability for the tax if such tax has been paid by the recipient of the income. The amount of any tax withheld and collected by a withholding agent is a special fund in trust for the United States (see section 3661.

Except as otherwise expressly indicated or manifestly inconsistent therewith all provisions of law, including statutes of limitations, applicable with respect to the assessment and collection and refund or credit of the taxes imposed by chapter 1 are applicable to the tax required to be collected at the source.

The withholding agent is relieved of liability to any other person for the amount of any tax withheld and paid to the collector pursuant to the provisions of section 466.

§ 29.467-2 *Quarterly adjustments*—(a) *In general.* If, for any quarter of the calendar year, more or less than the correct amount of the tax is withheld, or more or less than the correct amount of the tax is paid to the collector, proper adjustment, without interest, may be made in any subsequent quarter of the same calendar year. No adjustment, however, under the provisions of this section shall be made in respect of any quarter after the mailing of a statutory notice of deficiency under the provisions of section 272, the making of a jeopardy assessment under the provisions of section 273, or the filing of a claim for refund under the provisions of section 322, in respect of such quarter. Every return on which an adjustment for a preceding quarter is reported must have securely attached as a part thereof a statement, in duplicate, explaining the adjustment, and designating the quarterly return period in which the error occurred. If an adjustment of an overcollection of tax which the withholding agent has repaid to an employee is reported on a return, such statement shall include the fact that such tax was repaid to the employee.

(b) *Less than correct amount of tax withheld.* If none, or less than the correct amount, of the tax is deducted from any wage payment and the error is ascertained prior to the making of the return on Form V-1 for the quarter in which such wages are paid, the withholding agent shall nevertheless report on such return and pay to the collector the correct amount of the tax required to be withheld. If the error is not ascertained until after the making of the return on Form V-1 for the quarter in which such wages are paid, the undercollection may be corrected by an adjustment on the return for any subsequent quarter of the same calendar year, subject, however, to the limitations noted in paragraph (a). The amount of any undercollection, adjusted in accordance with this subsection shall be paid to the collector, without interest, at the time prescribed for payment of the tax for the quarter in which such adjustment is made. If an adjustment is made pursuant to this subsection but the amount thereof is not paid when due, interest thereafter accrues. See section 294.

If none, or less than the correct amount, of the tax is withheld from any wage payment, the withholding agent may correct the error by deducting the amount of the undercollection from remuneration of the employee, if any, under his control after he ascertains the error. Such deduction may be made even though the remuneration, for any reason, does not constitute wages. The obligation of an employee to the withholding agent with respect to an undercollection of tax from the employee's wages not subsequently corrected by a deduction made as prescribed herein is a matter for settlement between the employee and the withholding agent. In this connection, see section 466 (d) relieving the withholding agent from liability for collection of the tax if such tax has been paid by the employee or other recipient of the wages.

(c) *More than correct amount of tax withheld.* If, in any quarter, more than the correct amount of tax is deducted from any wage payment, the overcollection may be repaid to the employee in any quarter of the same calendar year. If the amount of the overcollection is repaid, the withholding agent shall obtain and keep as part of his records the written receipt of the employee showing the date and amount of the repayment.

If an overcollection in any quarter is repaid and receipted for by the employee prior to the time the return on Form V-1 for such quarter is filed with the collector, the amount of such overcollection shall not be included in the return for such quarter.

Subject to the limitations provided in paragraph (a) of this section, if an overcollection in any quarter is repaid and receipted for by the employee after the time the return on Form V-1 for such quarter is filed and the tax is paid to the collector, the overcollection may be corrected by an adjustment on the return for any subsequent quarter of the same calendar year.

Every overcollection not repaid and receipted for by the employee as provided in this subsection must be reported and paid to the collector with the return on Form V-1 for the quarter in which the overcollection is made.

SEC. 468. RETURN AND PAYMENT BY WITHHOLDING AGENT [as added by sec. 172 (a), Rev. Act 1942]:

In lieu of the time prescribed in sections 53 and 56 for the return and payment of the tax imposed by this chapter, every person required to withhold and collect any tax under section 466 shall make a return and pay such tax on or before the last day of the month following the close of each quarter of each calendar year. Every such person shall include with the final return for the calendar year a duplicate copy of each receipt required to be furnished under section 469. Every such person shall also keep such records and render under oath such statements with respect to the tax so withheld and collected as may be required under regulations prescribed by the Commissioner, with the approval of the Secretary.

§ 29.468-1 *Return and payment by withholding agent.* Every person required to withhold and collect any tax under section 466 shall make a return and pay such tax on or before the last day of the month following the close of each of the quarters ending March 31, June 30, September 30, and December 31. Such return is to be made on Form V-1, Return of Victory Tax Withheld, and must be filed with the collector of internal revenue for the district in which is located the principal place of business or office of the employer, or if he has no principal place of business or office, then in the district in which is located his legal residence. There shall be included with the return filed for the fourth quarter of the calendar year, or with the

employer's final return, if filed at an earlier date, a duplicate of each Statement of Victory Tax Withheld (Form V-2) (see § 29.469-1), together with Reconciliation of Quarterly Returns of Victory Tax Withheld with Statements of Victory Tax Withheld (Form V-3). In the case of a large number of duplicate statements (Form V-2), they may be forwarded to the collector in a separate package, properly identified by reference to the return (Form V-1). In such case Form V-3 should accompany the duplicate statements (Form V-2). Employers with numerous establishments or pay rolls should assemble the duplicate statements by establishment or by pay roll.

Every person required to withhold, collect, and pay any tax under section 466 shall keep such records as will indicate the persons employed during the year, payments to whom are subject to withholding, the periods of employment, and the amounts and dates of payment to such persons. Such records shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

The return must be signed and sworn to by the employer or other person required to withhold, collect, and pay the tax. The return may be sworn to before any person authorized by law to administer oaths for general purposes, or without charge, before any collector of internal revenue or deputy collector.

If the person required to withhold, collect, and pay the tax under section 466 is a corporation, the return shall be made in the name of the corporation and shall be sworn to by the president, vice president, or other principal officer.

With respect to any tax required to be withheld under section 466 by a fiduciary, the return shall be made in the name of the individual, estate, or trust for which such fiduciary acts, and shall be sworn to by such fiduciary. For returns made by one of two or more joint fiduciaries, see section 142 (b).

The last return on Form V-1 for any employer required to withhold, collect, any pay any tax under section 466 who ceased to pay wages shall be marked "Final return" by such employer. Such final return shall be filed with the collector on or before the thirtieth day after the date on which the final payment of wages is made for services performed for such employer, and shall plainly show the period covered and also the date of the last payment of wages. There shall be executed as part of each final return a statement, in duplicate, giving the address at which the records required by this section will be kept, the name of the person keeping such records and, if the business has been sold or otherwise transferred to another person, the name and address of such person and the date on which such sale or other transfer took effect. If no such sale or transfer occurred or the employer does not know the name of the person to whom the business was sold or transferred, that fact should be included in the statement. An employer who has only temporarily ceased to pay wages, including an employer engaged in seasonal activities, shall continue to file returns, but shall enter on the face of any return on which no tax is required to be reported a statement showing the date of the last payment of wages and the date when he expects to resume paying wages.

SEC. 469. RECEIPTS [as added by sec. 172 (a), Rev. Act 1942].

(a) *Wages.* Every employer required to withhold and collect a tax in respect of the wages of an employee shall furnish to each such employee in respect of his employment during the calendar year, on or before January 31 of the succeeding year, or, if his employment is terminated before the close of such calendar year, on the day on which the last payment of wages is made, a written statement showing the period covered by the statement, the wages paid by the employer to such employee during such period, and the amount of the tax withheld and collected under this part[1] in respect of such wages.

(b) *Regulations.* The statements required to be furnished by this section shall be in lieu of the return required to be furnished by the employer with respect to his employee under section 147 and shall be furnished at such other times, shall contain such other information, and shall be in such form as the Commissioner, with the approval of the Secretary, may by regulations prescribe.

(c) *Extension of time.* The Commissioner, under such regulations as he may prescribe with the approval of the Secretary, may grant to any employer a reasonable extension of time (not in excess of 30 days) with respect to the statements required to be furnished to employees on the day on which the last payment of wages is made.

§ 29.469-1 *Receipts for tax withheld at source on wages*—(a) *In general.* Every employer or other person required to withhold and collect a tax under section 466 shall furnish to each employee in respect of his employment during the calendar year a written statement on Form V-2, showing the period covered, the wages paid to the employee during such period, and the amount of tax withheld. The Form V-2 shall show all remuneration actually or constructively paid to the employee during the calendar year whether or not constituting wages and whether or not tax has been withheld therefrom. Statements prepared in substantially like form and size, but in no case larger than 8 by 3½ inches, will be acceptable. This statement shall be furnished to the employee on or before January 31 of the succeeding calendar year, or, if his employment is terminated before the close of such calendar year, on the day on which the last payment of wages is made. Statements of Victory Tax Withheld (Form V-2) shall be prepared in duplicate, the original of which shall be furnished to the employee as prescribed. The duplicate statements shall be transmitted to the collector with Form V-1 for the fourth quarter of the calendar year and Form V-3.

For wages, salaries, or other remuneration paid in 1943 and subsequent years, the statement on Form V-2 shall take the place of Form 1099, Information Return.

(b) *Extension of time in case of termination of employment.* An extension of time, not exceeding 30 days, within which to furnish the statement required by section 469 (a) is granted any employer with respect to any employee whose employment is terminated during the calendar year. In the case of intermittent or interrupted employment where there is reasonable expectation on the part of both employer and employee of further employment, there is no requirement that a statement be immediately furnished the employee; but when such expectation ceases to exist, the statement must be furnished within 30 days from that time.

SEC. 470. PENALTIES [as added by sec. 172 (a), Rev. Act 1942].

(a) *Penalties for fraudulent receipt or failure to furnish receipt.* In lieu of any other penalty provided by law (except the penalty provided by subsection (b) of this section), any person required under the provisions of section 469 to furnish a receipt in respect of tax withheld pursuant to this part[1] who wilfully furnishes a false or fraudulent receipt, or who wilfully fails to furnish a receipt in the manner, at the time, and showing the information required under section 469, or regulations prescribed thereunder, shall for each such failure, upon conviction thereof, be fined not more than $1,000, or imprisoned for not more than one year, or both.

(b) *Additional penalty.* In addition to the penalty provided by subsection (a) of this section, any person required under the provisions of section 469 to furnish a receipt in respect of tax withheld pursuant to this part[1] who wilfully furnishes a false or fradulent receipt, or who wilfully fails to furnish a receipt in the manner, at the time, and showing the information required under section 469, or regulations prescribed thereunder, shall for each such failure be subject to a civil penalty of not more than $50.

(c) *Failure of withholding agent to file return.* In case of any failure to make and file return required by this part,[1] 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 wilful neglect, the addition to the tax provided for in section 291 shall not be less than $5.

§ 29.470-1 *Penalties*—(a) *Fraudulent receipt or failure to furnish receipt.* Section 470 imposes criminal and civil penalties for the willful failure to furnish a receipt in the manner, at the time, and showing the information required under section 469 or regulations prescribed thereunder or for willfully furnishing a false or fraudulent receipt. The criminal penalty is a fine of not more than $1,000 or imprisonment for not more than one year, or both, and the civil penalty is a fine of not more than $50 for each such violation. Such penalties are in lieu of any other penalties provided by law respecting the failure to furnish a receipt or the furnishing of a false or fraudulent receipt.

(b) *Addition to tax for failure to file return.* In case of any failure to make and file a return required by section 468 within the time prescribed by law, 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 addition to the tax provided by section 291 shall not be less than $5. For interest and additions to tax for failure to make return or pay tax within the time prescribed by law, see generally sections

[1] This part comprises sections 465 to 470, inclusive.

291 to 299, inclusive; for criminal penalties, see section 145 and § 29.145-1.

EXPIRATION DATE AND DEFINITIONS

SEC. 475. DEFINITIONS [as added by sec. 172 (a), Rev. Act 1942].

(a) *Net income.* When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term "net income" shall be construed to mean "victory tax net income" for the purposes of this subchapter.

(b) *Date of cessation of hostilities in the present war.* As used in this subchapter, the term "date of cessation of hostilities in the present war" means the date on which hostilities in the present war between the United States and the governments of Germany, Japan, and Italy cease, as fixed by proclamation of the President or by concurrent resolution of the two Houses of Congress, whichever date is earlier, or in case the hostilities between the United States and such governments do not cease at the same time, such date as may be so fixed as an appropriate date for the purposes of this subchapter.

§ 29.475-1 *Definitions*—(a) *Net income as victory tax net income.* The term "net income" as used throughout the Internal Revenue Code, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, shall be construed to mean "victory tax net income" for the purposes of the victory tax.

(b) *Date of cessation of hostilities in the present war.* The term "date of cessation of hostilities in the present war" means the date on which hostilities in the present war between the United States and the Governments of Germany, Japan, and Italy cease, as fixed by proclamation of the President or concurrent resolution of both Houses of Congress, whichever date is earlier, or, in case the hostilities between the United States and such Governments do not cease at the same time, such date as may be fixed by proclamation of the President or by concurrent resolution of both Houses of Congress as an appropriate date for the purposes of the victory tax.

SEC. 476. EXPIRATION DATE [as added by sec. 172 (a), Rev. Act 1942, and amended by sec. 2 (c), Current Tax Payment Act 1943].

The tax imposed by Part I[1] of this subchapter shall not apply with respect to any taxable year commencing after the date of cessation of hostilities in the present war. The tax imposed by Part II[1] of such subchapter shall not apply with respect to any wages paid after June 30, 1943, unless paid during the calendar year 1943 with respect to a payroll period beginning on or before such date. [NOTE. Under sec. 2 (d), Current Tax Payment Act 1943, the amendment by sec. 2 (c) thereof is effective July 1, 1943. Prior to such amendment, section 476 read as follows: "The taxes imposed by this subchapter shall not apply with respect to any taxable year commencing after the date of cessation of hostilities in the present war."]

SUBPART E—PERSONAL HOLDING COMPANIES

SEC. 500. SURTAX ON PERSONAL HOLDING COMPANIES [as amended by sec. 203, Rev. Act 1940; sec. 110 (a), Rev. Act 1941; sec. 181, Rev. Act 1942].

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.

[NOTE: Under sec. 101, Rev. Act 1942, the rates of tax specified in this section are applicable only with respect to taxable years beginning after December 31, 1941.]

§ 29.500-1 *Surtax on personal holding companies.* 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 § 29.501-1, 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.

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.

SEC. 501. DEFINITIONS OF PERSONAL HOLDING COMPANY [as amended by secs. 182 (a), 183, Rev. Act. 1942.]

(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 licensed personal finance company under State supervision, at least 80 per centum of the gross income of which is lawful interest received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed $300 in principal amount, if such interest is not payable in advance or compounded and is computed only on unpaid balances.

(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.

[NOTE: Sec. 182 (b), Rev. Act, 1942, provides that the amendment of sec. 501 (b), Internal Revenue Code, by sec. 182 (a), Rev. Act 1942, shall be applicable "to taxable years beginning after December 31, 1941, except that if a taxpayer, within the time and in the manner and subject to such regulations as the Commissioner with the approval of the Secretary prescribes, elects to have such amendments apply retroactively to all taxable years of the taxpayer beginning after December 31, 1938, and not beginning after December 31, 1941, such amendments shall be applicable to such taxable years."]

(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.

§ 29.501-1 *Definition of personal holding company.* A personal holding company is any corporation (other than a corporation specified in section 501 (b)) which for the taxable year meets (a) the gross income requirement specified in § 29.501-2, and (b) the stock ownership

[1] Part I comprises sections 450 to 456, inclusive. Part II comprises sections 465 to 470, inclusive.

requirement specified in § 29.501-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

A loan or investment corporation, as defined in section 501 (b) (7), is not taxable as a personal holding company. If, for any prior taxable year (or years) beginning after December 31, 1938, and before January 1, 1942, such a corporation classifies as a personal holding company under section 501 (a), it is not subject to the surtax imposed by section 500 for such taxable year (or years) if it elects, within one year after October 21, 1942, not to be so taxed. The election can be made only by the filing of a notice in writing with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, within such 1-year period, requesting that the exemption granted by section 501 (b) be applied to such prior taxable year (or years) with respect to which the corporation was otherwise subject to surtax as a personal holding company.

§ 29.501-2 *Gross income requirement.* To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year be personal holding company income as defined in section 502:

(a) 80 percent or more; or

(b) 70 percent or more if the corporation has been classified as a personal holding company for any taxable year beginning after December 31, 1936, unless:

(1) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 501 (a) (2) exists; or

(2) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its personal holding company income was less than 70 percent of its gross income.

In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and §§ 29.22 (a)-1 to 29.22 (a)-20, inclusive.

§ 29.501-3 *Stock ownership requirement.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than five individuals. For such purpose, the ownership of the stock must be determined as provided in section 503 and §§ 29.503 (a)-1 to 29.503 (a)-7, inclusive, and § 29.503 (b)-1.

In the event of any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration.

In determining whether the statutory conditions with respect to stock ownership are present at any time during the last half of the taxable year, the phrase "in value" shall, in the light of all of the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

The rules stated in the last two preceding paragraphs are equally applicable in determining the stock ownership requirement specified in section 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.

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 shareholder.* Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement.

(g) *Rents.* Rents, unless constituting 50 per centum or more of the gross income. For the purposes of this subsection, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (f).

(h) *Mineral, oil, or gas royalties.* Mineral, oil, or gas royalties, unless (1) constituting 50 per centum or more of the gross income, and (2) the deductions allowable under section 23 (a) (relating to expenses) other than compensation for personal services rendered by shareholders, constitute 15 per centum or more of the gross income.

§ 29.502-1 *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 § 29.115-1.

(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 orginally 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.* 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:

(1) 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) 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 503 and §§ 29.503 (a)-1 to 29.503 (a)-7, inclusive, § 29.503 (b)-1, and the last paragraph of § 29.501-3.

The application of section 502 (a) may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example (2). The N Corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute personal holding company income.

(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 §§ 29.503 (a)-1 to 29.503 (a)-7, inclusive, § 29.503 (b)-1, and the last pargaraph of § 29.501-3.

(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.* The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (1) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (2) the aggregate amount of deductions allowable for expenses under section 23 (a) (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

The term "mineral, oil, or gas royalties" means all royalties, except overriding royalties, received from any interest in mineral, oil, or gas properties. The term "mineral" includes the minerals specified in § 29.23 (m)-1 (d). As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

SEC. 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).

§ 29.503 (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 § 29.501-3, 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 § 29.502-1, 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 § 29.502-1,

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 §§ 29.503 (a)-2 to 29.503 (a)-7, inclusive, and § 29.503 (b)-1. 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.

§ 29.503 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (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 § 29.503 (a)-6.

§ 29.503 (a)-3 *Family and partnership ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (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.

The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in § 29.503 (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	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 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.

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 § 29.503 (a)-1 (a) and (b).

§ 29.503 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (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.

§ 29.503 (a)-5 *Application of family-partnership and option rules.* The family and partnership rule provided in section 503 (a) (2) and § 29.503 (a)-3 and the option rule provided in section 503 (a) (3) and § 29.503 (a)-4 shall be applied:

(a) For the purpose stated in § 29.503 (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 § 29.503 (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 § 29.503 (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 § 29.503 (a)-1.

§ 29.503 (a)-6 *Constructive ownership as actual ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1:

(a) 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 § 29.503 (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 § 29.503 (a)-3) in order to make another person the constructive owner of such stock, and

(b) Stock constructively owned by a person by reason of the application of the option rule provided in section 503 (a) (3) (see § 29.503 (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

(c) 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.

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 § 29.503 (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.

§ 29.503 (a)-7 *Option rule in lieu of family and partnership rule.* If, in determining the ownership of stock for any of the purposes set forth in § 29.503 (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 § 29.503 (a)-3) and the option rule provided in section 503 (a) (3) (see § 29.503 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

The application of this 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 § 29.503 (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 § 29.503 (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 § 29.503 (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 consrtuctive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

[SEC. 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.

§ 29.503 (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 1942, 1943, and 1944, those convertible in 1942 can be properly considered as outstanding stock without so considering those convertible in 1943 or 1944, and those convertible in 1942 and 1943 can be properly considered as outstanding stock without so considering those convertible in 1944. However, the securities convertible in 1943 could not be properly considered as outstanding stock without so considering those convertible in 1942 and the securities convertible in 1944 could not be properly considered as outstanding stock without so considering those convertible in 1942 and 1943.

SEC. 504. UNDISTRIBUTED SUBCHAPTER A NET INCOME [as amended by sec. 228 (a), Rev. Act 1939; sec 1, Pub. Law 18, approved March 17, 1941; secs. 132 (d), 184 (a), 186 (c), Rev. Act 1942].

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, by the amount allowed under section 405 (c) of the Revenue Act of 1938 in the computation of the tax under Title IA of such Act for a taxable year beginning prior to January 1, 1939); and

(B) The consent dividends credit for the taxable year.

(d) Amounts distributed before January 1, 1944, in redemption of preferred stock outstanding before January 1, 1934 (including any preferred stock issued after January 1, 1934, in lieu of such previously outstanding preferred stock) if such distributions are made by a corporation the aggregate of whose gross sales and gross receipts arising from manufacturing, commerical, processing, and service operations during the four-year period immediately before January 1, 1934, exceeded the aggregate of its gross receipts from dividends, interest, royalties, annuities, and gains from the sale or exchange of stock or securities during such period.

SEC. 186. DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES. (Revenue Act of 1942, title I.)

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(g) *Retroactive application.* The amendments made by subsections (a) to (d), inclusive [the amendments of sections 115 (a), 115 (b), 504 (c), and 506 (c), Internal Revenue Code], shall not apply with respect to any distribution, which is a dividend solely by reason of the last sentence of section 115 (a) of the applicable revenue law, made prior to the date of enactment of this Act by 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 it 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, unless—

(1) The corporation (under regulations prescribed by the Commissioner with the approval of the Secretary) files, within one year after the date of the enactment of this Act, a claim for the benefit of this section on account of such distribution;

(2) Such claim is accompanied by signed consents made under oath by each person to whom the corporation made such distribution agreeing to the inclusion of the amount of such distribution to him in his gross income as a taxable dividend. If any such person is no longer in existence or is under disability then the consent may be made by his legal representative; and

(3) Each such 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 of the applicable revenue law to be deducted and withheld by the corporation if the amount of the distribution to the shareholder had been paid to the shareholder in cash as a dividend. The amount accompanying such consent shall be credited against the tax under the applicable revenue law imposed by section 211 (a) or 231 (a) upon the shareholder.

(h) *Overpayments and deficiencies.* If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of subsections (e) [amendment of section 28 (d), Internal Revenue Code] and (g) of this section is prevented on the date of the enactment of this Act or within one year from such date, then, notwithstanding any other provision of law or rule of law (other than this subsection and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected if claim therefor is filed within one year from the date of the enactment of this Act If the assessment or collection of any deficiency for any taxable year, to the extent resulting from the application of subsections (e) and (g) of this section, is prevented on the date of the filing of the shareholders' consents referred to in subsection (e) or on the date of filing of the claim referred to in subsection (g) (1) or within one year from the date of filing of such consents or claim, as the case may be, then, notwithstanding any other provision of law or rule of law, such deficiency shall be assessed and collected if assessment is made within one year from the date of the filing of such consents or claim, as the case may be. The failure of a shareholder to include in his gross income for the proper taxable year the amount specified in the consent made by him referred to in subsection (g) (2) shall have the same effect, with respect to the deficiency resulting therefrom, as is provided in section 272 (f) of the applicable revenue law with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

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§ 29.504-1 *Undistributed Subchapter A net income.* The term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505 and § 29.505-1) minus (a) the amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraph (3), relating to the deficit credit, and paragraph (4), relating to the debt credit, thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations), (b) amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and the terms of such indebtedness (see § 29.504-2), (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, and (d) amounts distributed in redemption of preferred stock outstanding prior to January 1, 1934 (including preferred stock subsequently issued in lieu thereof), but only if such distributions are made before January 1, 1944, for taxable years beginning after December 31, 1940, by a corporation specified in section 504 (d). 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.

§ 29.504-2 *Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934*—(a) *Indebtedness.* The term "indebtedness" means an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount. The term "indebtedness" does not include the obligation of a corporation on its capital stock.

The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer prior to January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of renewal or other changes in the form of an indebtedness, so long as the relationship of debtor and creditor continues between the taxpayer and his creditor, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(b) *Amounts used or irrevocably set aside.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. Since, therefore, in the case of renewal and other changes in the form of an indebtedness, the relationship of debtor and creditor continues between the taxpayer and his creditor, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and, as well, all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions are not permitted.

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

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

All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to

trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the statutory requirement of reasonableness. To be considered reasonable it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted prior to 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(d) *General.* The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the Commissioner may require in substantiation of the deduction claimed.

§ 29.504-3 *Retroactive application.* If any distribution, which is a dividend solely by reason of the last sentence of section 115 (a), was made prior to October 21, 1942, by a corporation which, under the revenue law applicable to the taxable year in which the distribution was made, was a personal holding company, or which, for the taxable year in respect of which it is made under section 504 (c) or section 506 or a corresponding provision of a prior income tax law, was a personal holding company under the law applicable to such taxable year, the corporation is entitled to a dividend paid credit for any taxable year in which, or with respect to which, the distribution was made, provided:

(a) The corporation files with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within one year after October 21, 1942, a claim for the benefit of section 186 of the Revenue Act of 1942, on account of any distribution, which is a dividend by reason of the last sentence in section 115 (a), made before October 21, 1942;

(b) Such claim is accompanied by signed consents made on oath or affirmation on Form 972, as provided in § 29.504-5, by each shareholder to whom the corporation made such distribution agreeing to the inclusion of the amount of such distribution as a taxable dividend in his gross income for the taxable year in which it is made; and

(c) Each such consent filed is accompanied by payment of an amount equal to that which would be required by section 143 (b) or 144 of the applicable revenue law to be deducted and withheld by the corporation if the amount of the distribution to the shareholder had been paid to the shareholder in cash as a dividend.

§ 29.504-4 *Claim for benefit of section 186 of the Revenue Act of 1942*—(a) *General.* A claim for the benefit of section 186 of the Revenue Act of 1942 must be filed within one year after October 21, 1942, claiming credit for any distribution, which is a dividend solely by reason of the last sentence of section 115 (a).

(b) *Form of claim.* The claim for such credit shall be made in duplicate, under oath or affirmation, on Form 973B, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* 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) Taxable year or years for which the benefit of a credit is claimed;

(3) Amount of distribution which is a dividend solely by reason of the last sentence of section 115 (a) and date of payment thereof;

(4) Amount of distribution previously allowed, if any, as a dividends paid credit, and amount of distribution previously disallowed as a dividends paid credit and for which signed consents accompany the claim;

(5) Whether the corporation was a personal holding company under the law applicable to the taxable year in which the distribution was made or for the taxable year in respect of which it was made under sections 504 (c) or 506 or a corresponding provision of a prior income tax law;

(6) Amount of tax to be eliminated, refunded, or credited; and

(7) Such other information as may be required by the claim form.

§ 29.504-5 *Making and filing of consents.* A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with these regulations and the instructions on the form or issued therewith and may be made only by or on behalf of the shareholder to whom the corporation made the distribution. In the consent it must be agreed that such distribution shall be included as a taxable dividend in the gross income for the taxable year in which the distribution is made.

A consent may be made at any time not later than one year after October 21, 1942. Within such time the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973B, showing the class and number of shares of each class held at date of dividend payment, amount previously considered taxable, amount previously considered nontaxable, and all other information required by the form.

In the event that any consent filed by the corporation is made by a shareholder from whom, if the amount of the distribution had been paid in cash as a dividend, the corporation would have been required to deduct and withhold any amount as a tax under section 143 (b) or 144, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount of the distribution had been paid in cash as a dividend. Such payment must be in one of the following forms:

(a) Cash;

(b) United States postal money order;

(c) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(d) A cashier's check of a domestic bank; or

(e) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

§ 29.504-6 *Overpayments and deficiencies*—(a) *Overpayments.* If, as a result of the application of section 186 of the Revenue Act of 1942, any overpayment is established or determined with respect to the personal holding company tax for any year and a claim is filed within one year after October 21, 1942, for the credit or refund of such overpayment, and if, on October 21, 1942, or within one year thereafter, such credit or refund would otherwise be prevented, then notwithstanding any other provision of law or rule of law (other than section 186 (h) of the Revenue Act of 1942, and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected.

(b) *Deficiencies.* If, as a result of the application of section 186 of the Revenue Act of 1942, a deficiency is established or determined with respect to the personal holding company tax for any year, and if, on the date of the filing of the consents referred to in subsection (e) of that section, or on the date of filing of the claim referred to in subsection (g) (1) of that section, or within one year from the date of filing such consents or claim, as the case may be, the assessment or collection of such deficiency is prevented, then, notwithstanding any other provision of law or rule of law, the deficiency shall be assessed and collected if assessment is made within one year from the filing of such consents or claim, as the case may be.

(c) *Amounts not included in shareholder's return.* If a shareholder fails to include in his gross income for the proper taxable year the amount specified in section 186 (g) (2) of the Revenue Act of 1942, such failure shall have the same effect with respect to the deficiency resulting therefrom as is provided in section 272 (f) of the Internal Revenue Code with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

SEC. 505. SUBCHAPTER A NET INCOME [as amended by secs. 211, 212, Rev. Act 1939; secs. 135 (b), 150 (i), Rev. Act 1942].

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.

(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.* The net income shall be computed without regard to section 117 (e) (2).

(e) *Income not placed on annual basis.* The net income shall be computed without regard to section 47 (c).

§ 29.505-1 *Subchapter A net income.* 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).

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.

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.

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), (c), and (d) 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. Section 505 (d) provides the same treatment to personal holding companies with respect to capital gains and losses as ordinary corporations, except that no capital loss carry-over pursuant to section 117 (e) (2) is allowed from the last taxable year beginning in 1941. 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:

(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.

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.

§ 29.505-2 *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:

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 1942:

The net income, as computed under chapter 1, amounts of $190,000.

Federal income tax imposed by sections 13 and 15 was paid March 15, 1942, in the amount of $17,500.

Contributions or gifts payment of which is made to or for the use of donees described in section 23 (q) for the purposes therein specified amount to $35,000, of which $10,000 is deducted in arriving at the net income under chapter 1.

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 §29.505-1.

Dividends paid by the corporation to its shareholders during the taxable year which are allowable as a credit under section 27 (a) amount to $125,000.

The amount used during the year to pay indebtedness incurred by the corporation prior to January 1, 1934, is $31,250.

On March 1, 1943, 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 $12,500, that being 10 percent of the dividends paid during the taxable year 1942.

The subchapter A net income, the undistributed subchapter A net income, and the surtax are computed as follows:

Net income under chapter 1		$190,000
Add:		
Contributions deductible in computing net income under section 21		10,000
Aggregate of expenses and depreciation relating to the country estate in excess of the income derived therefrom		25,000
Net income computed without the benefit of a deduction for contributions and without the benefit of the amount disallowed under section 505 (b)		225,000
Less:		
Federal income tax	$17,500	
Contributions deductible under section 505 (a) (2) (15 percent of $225,000)	33,750	
		51,250
Subchapter A net income		173,750
Less:		
Dividends paid credit	$125,000	
Amount used to pay indebtedness	31,250	
		156,250
Undistributed subchapter A net income before applying section 504 (c)		17,500
Dividends paid March 1, 1943 (subject to limitation in section 504 (c) (3))		12,500
Undistributed subchapter A net income		5,000
Amount taxable at 75 percent (not in excess of $2,000)		2,000
Amount taxable at 85 percent ($5,000 minus $2,000)		3,000
Surtax on $2,000 at 75 percent		1,500
Surtax on $3,000 at 85 percent		2,550
Total surtax		4,050

SEC. 506. DEFICIENCY DIVIDENDS; CREDITS AND REFUNDS [as amended by sec. 1, Pub. Law 18, approved March 17, 1941; secs. 185, 186 (d) (1), Rev. Act 1942].

(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 [known as The Tax Court of the United States] 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. [NOTE.—With respect to the amendment of this provision by sec. 186 (d), Rev. Act 1942, see sec. 186 (g) (h), Rev. Act 1942, set forth immediately following sec. 504, Internal Revenue Code.]

(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 of judgment becomes final, as the case may be.

(C) If claim for deficiency divided 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.* If the deficiency is established or determined for a taxable year which begins after December 31, 1939, and does not begin after December 31, 1941, the rates under subsections (a) and (b) used in determining the amount of the credit or refund shall be 71½ per centum in lieu of 65 per centum and 82½ per centum in lieu of 75 per centum.

(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.

(j) [1] *Additional credit or refund for prior taxable year*—(1) *Election to have a certain dividend considered as a deficiency dividend.* If a corporation was a personal holding company for any taxable year beginning after December 31, 1936, and prior to January 1, 1942, and its adjusted net income, Title 1A net income or Subchapter A net income, in the case of a tax imposed by Titles 1A of the Revenue Acts of 1936 and 1938, or Subchapter A of the Internal Revenue Code, as the case may be, exceeds the sum of (A) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year and (B) the earnings and 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) and if prior to the date of enactment of the Revenue Act of 1942, the corporation paid all or any portion of the tax imposed by Title 1A or Subchapter A for any such taxable year or years then the corporation may elect, within six months after the date of enactment of the Revenue Act of 1942 to have the amount of a dividend paid within such six-month period considered as a deficiency dividend. Such election must be made by the filing of a claim (under regulations prescribed by the Commissioner with the approval of the Secretary) within such six-month period and after the payment of the dividend, specifying the taxable year or years with respect to which such dividend applies, setting forth the amount of the dividend to be apportioned to each taxable year, and claiming the benefit of this subsection by reason of such dividend.

(2) *Effect of election.* If the corporation exercises the election authorized under paragraph (1) of this subsection—

(A) The credit or refund shall be computed, and credited or refunded without interest, as provided in subsection (b) and at the rates provided therein or in subsection (g), as the case may be, but shall be subject to the limitations in subsection (f). In any case where a dividend is apportioned to more than one taxable year the credit or refund shall be determined for each taxable year on the basis of the amount of the dividend apportioned thereto; and

(B) The dividends paid credit for the taxable year in which paid and for a prior taxable year or years shall be determined as provided in subsection (c) (2).

[1] No subsection (i).

§ 29.506-1 *Purpose and scope of deficiency dividend credit.* Section 506 provides a method under which, by virtue of dividend distributions, a corporation may, under certain conditions (see § 29.506-3), 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 § 29.506-4), 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 § 29.27 (b)-2.

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).

§ 29.506-2 *Date when decision by Tax Court or court becomes final and date of closing agreement.* The date upon which a decision by The Tax Court of the United States becomes final is prescribed in section 1140.

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.

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.

§ 29.506-3 *Credit against unpaid deficiency*—(a) *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, under oath or affirmation, on Form 975, copies of which, upon request, may be procured from any collector.

(c) *Contents of notification.* The notification shall, in accordance with the provisions of this 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, D. C., attention Income Tax Unit, Records Division, within 30 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or

judgment becomes final, as the case may be.

(e) *Claim for deficiency dividends credit.* For claims for deficiency dividends credits, see § 29.506-5.

§ 29.506-4 *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.

§ 29.506-5 *Claim for deficiency dividends credit or credit or refund*—(a) *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, under oath or affirmation, on Form 976, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* There shall be attached to and made a part of the claim a certified copy of the resolution of the board of directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed. In addition the claim shall, in accordance with the provisions of this 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, D. C., attention Income Tax Unit, Records Division, within 60 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or judgment becomes final, as the case may be.

§ 29.506-6 *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).

§ 29.506-7 *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.

§ 29.506-8 *Retroactive application.* For regulations relating to making and filing of the claims and consents referred to in subsections (d) (1) and (g) of section 186 of the Revenue Act of 1942, see §§ 29.504-3, 29.504-4, and 29.504-5.

§ 29.506-9 *Overpayments and deficiencies.* For the refund or credit of any overpayment, and the assessment or collection of any deficiency referred to in section 186 (h) of the Revenue Act of 1942, see § 29.504-6.

§ 29.506-10 *Election to have a certain dividend considered as a deficiency dividend.* Section 506 (j) is designed to be used particularly in those cases where a corporation was a personal holding company for certain taxable years beginning prior to January 1, 1942, and the personal holding company tax has been paid in whole or in part prior to October 21, 1942, for such taxable years. In such a case the corporation may elect to have the amount of a dividend paid within six months after October 21, 1942, to shareholders to whom the distribution is made, considered as a deficiency dividend under the following conditions, qualifications, and limitations:

(a) It must be established by the corporation that its income, upon which the personal holding company tax is imposed, exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year and (2) the earnings and profits of the taxable year (computed as of the close of such year without diminution by reason of any distributions made during the taxable year);

(b) The corporation is required to make an election within six months after October 21, 1942, to have the amount of a dividend paid within such 6-month period treated as a deficiency dividend;

(c) The election must be made by the filing of a claim for credit or refund within such 6-month period;

(d) The dividend must be paid prior to the filing of the claim for credit or refund and the shareholders to whom the distribution is made must include such distribution as a taxable dividend in their returns for the taxable year in which such distribution is made;

(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 of the United States on refunds or credits);

(f) No credit or refund shall be made under section 506 (j), with respect to any amount of tax paid on or after October 21, 1942; and

(g) No interest shall be allowed on the credit or refund.

§ 29.506-11 *Claim for additional credit or refund for prior taxable year*—(a) *General.* A claim for additional credit or refund under section 506 (j), relating to election to have a certain dividend treated as a deficiency dividend, must be filed within six months after October 21, 1942, claiming the benefit of that section by reason of a dividend paid within such 6-month period.

(b) *Form of claim.* The claim for additional credit or refund under this section shall be made in duplicate, on oath or affirmation, on Form 976A, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* There shall be attached to and made a part of the claim a certified copy of the resolution of the board of directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed. In addition the claim shall, in accordance with the provisions of this 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 personal holding company tax imposed for each of the taxable years involved; if tax paid (in whole or in part), date of payment and amount thereof;

(4) The amount of the income, upon which the personal holding company tax is imposed, in excess of the sum of the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and the earnings and profits of the taxable year (computed as of the close of such year without diminution by reason of any distributions made during the taxable year);

(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 date the dividend was paid, the taxable year or years with respect to which such dividend applies, and the amount of the dividend to be apportioned to each taxable year;

(7) The amount claimed as a credit or refund; and

(8) Such other information as may be required by the claim form.

§ 29.506-12 *Effect of election.* If the corporation elects to have a distribution made within six months after October 21, 1942, considered as a deficiency dividend as provided in section 506 (j), and files the claim required by that section:

(a) The credit or refund shall be computed, and credited or refunded without interest, as provided in section 506 (b) and at the rates provided therein or in section 506 (g), as the case may be. However, such credit or refund shall not be allowed with respect to any deficiency attributable, in whole or in part, to fraud with intent to evade the tax or to a failure to file a timely return without reasonable cause for such failure. See section 506 (f). In any case where a dividend is apportioned to more than one taxable year the credit or refund shall be determined for each taxable year on the basis of the amount of the dividend apportioned thereto; and

(b) The dividends paid credit for the taxable year in which paid and for a prior taxable year or years shall be determined in the manner prescribed in section 506 (c) (2).

SEC. 507. MEANING OF TERMS USED [as amended by sec. 227 (a), Rev. Act 1939].

(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. 503. 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.

§ 29.503-1 *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.

§ 29.503-2 *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.

SEC. 503. 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—DEFINITIONS

SEC. 3797. DEFINITIONS [as amended by secs. 120 (f), 511, Rev. Act 1942.]

(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.

(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 personal 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 Reverse 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), 25 (b), (2) (A), and 171, and the last sentence of section 401 (a) (2), 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".

(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, § 1).

Plural as including singular, R.S. 1 (U.S.C., Title 1, § 1).

Masculine as including feminine, R.S. 1 (U.S.C., Title 1, § 1).

Officer, R.S. 1 (U.S.C., Title 1, § 1).

Oath as including affirmation, R.S. 1 (U.S.C., Title 1, § 1).

Company or association as including successors and assigns, R.S. 5 (U.S.C., Title 1, § 5).

County as including parish, R.S. 2 (U.S.C., Title 1, § 2).

Vessels as including all means of water transportation, R.S. 3 (U.S.C., Title 1, § 3).

Vehicle as including all means of land transportation, R.S. 4 (U.S.C., Title 1, § 4).

§ 29.3797-1 *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 § 29.3797-3.) 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 § 29.3797-4.) 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 §§ 29.3797-2 and 29.3797-4.) The definitions, terms, and classifications, as set forth in section 3797, shall have the same respective meaning and scope in these regulations.

§ 29.3797-2 *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 "investment" trust (whether of the fixed or the management type), an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

§ 29.3797-3 *Association distinguished from trust.* 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 beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph 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.

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.

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 organiaztion 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.

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.

§ 29.3797-4 *Partnerships.* 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 §§ 29.3797-2 and 29.3797-3. The following examples will illustrate some phases of these distinctions:

(a) 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.

(b) 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.

§ 29.3797-5. *Limited partnerships.* 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.

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.

§ 29.3797-6 *Partnership association.* 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.

§ 29.3797-7 *Insurance company.* Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Internal Revenue Code. For example, during the year 1942 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeeng 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 1942 within the meaning of the Code and these regulations.

§ 29.3797-8 *Domestic, foreign, resident, and nonresident persons.* A domestic corporation is one organized or created in the United States, including only the States, the territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory, and a foreign corporation is one which is not domestic. A domestic corporation is a resident corporation even though it does no business and owns no property in the United States. A foreign corporation engaged in trade or business within the United States 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 these regulations, includes a nonresident alien individual and a nonresident alien fiduciary.

§29.3797-9 *Fiduciary.* "Fiduciary" is a term which applies to persons who occupy positions of pecular 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.

§ 29.3797-10 *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.

§ 29.3797-11 *Military or naval forces of the United States.* The term "military or naval forces of the United States" is defined in section 3797 (a) (15). The term includes, among other organizations, the Coast Guard, which in turn includes the Coast Guard Reserve, of which the Women's Reserve is a branch. The definition in section 3797 (a) (15) is inclusive only and not exclusive.

SUBPART G—MITIGATION OF EFFECT OF LIMITATION AND OTHER PROVISIONS IN INCOME TAX CASES

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 [known as The Tax Court of the United States] 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.

§ 29.3801 (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 §§ 29.3801 (b)-1 to 29.3801 (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.

§ 29.3801 (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.

§ 29.3801 (a) (1)-3 *Decision by tax court or court as a determination.* 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.

The date upon which a decision by The Tax Court becomes final is prescribed in section 1140.

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.

§ 29.3801 (a) (1)-4 *Final disposition of claim for refund as a determination.* 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 disposition 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.

(a) *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.

(b) *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, under the Commissioner's computation but under the Commissioner's computation the consequent overpayment 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.

(c) *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).

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 (b) or (c) of this section by the use of a closing agreement to effect a determination.

[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.

§29.3801 (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, and 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 § 29.3801 (b)-8 for the requirement in certain cases that the relationship exists at the time an inconsistent position is first maintained.

[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 [known as The Tax Court of the United States] 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.

§ 29.3801 (b)-0 *Circumstances of adjustment.* 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, whether before, on, or after May 28, 1938 (the date of enactment of the Revenue Act of 1938), 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 period of limitation has expired).

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.

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.

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.

§ 29.3801 (b)-1 *Double inclusion of item of gross income.* 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.

Example (1). A taxpayer who keeps his books on the cash basis erroneously included in his return for 1934 an item of accrued rent. In 1939, after the period of limitations on refunds for 1934 has expired, the Commissioner discovers that the taxpayer received his rent in 1935 and asserts a deficiency for the year 1935, which is sustained by The Tax

Court of the United States in 1942. An adjustment is authorized with respect to the year 1934. If the taxpayer had returned the rent for both 1934 and 1935 and by a determination was denied a refund claimed for 1935 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 1940. 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 1940 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 1940. Thereafter, the Commissioner asserts a deficiency against the husband on account of the omission of such salary from his return for 1940. The husband unsuccessfully contests the deficiency before The Tax Court in 1942. An adjustment is authorized with respect to the wife's tax for 1940.

§ 29.3801 (b)-2 *Double allowance of a deduction or credit.* 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.

Example (1). A taxpayer in his return for 1937 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently it was discovered that the forest fire occurred in 1938 rather than in 1937. After the expiration of the period of limitations for the assessment of a deficiency for 1937, the taxpayer files a claim for refund for 1938 based upon a deduction for the fire loss in that year. The Commissioner in 1942 allows the claim for refund. An adjustment is authorized with respect to the year 1937.

Example (2). The beneficiary of a testamentary trust in his return for 1936 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1936 with respect to a different item and final decision of The Tax Court of the United States was rendered in 1938, so that the Commissioner was thereafter barred by section 272 (f) of the Revenue Act of 1936 from asserting a further deficiency against the beneficiary for 1936. 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 1942 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1936.

§ 29.3801 (b)-3 *Erroneous exclusion of item of gross income with respect to which tax was paid.* 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.

Example (1). A taxpayer received payments in 1939 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 1938. The taxpayer subsequently filed claim for refund for the year 1939, asserting that he kept his books on the accrual basis and that, as the payments had accrued in 1938, they were properly taxable in that year. The claim for refund is allowed in 1942. An adjustment is authorized with respect to the year 1938. If the taxpayer had not included the payments in any return and the Commissioner had asserted a deficiency for 1939 with respect to the payments, and the deficiency is not sustained by The Tax Court of the United States in its final decision in 1943, no adjustment is authorized with respect to the year 1938. Although the determination requires the exclusion of the item from gross income, no tax has been paid with respect thereto. If the taxpayer, however, had paid the deficiency and thereafter successfully contested it before The Tax Court or 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 1935 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 repsect to deficiency assessments and refund claims for both father and son for 1935, the father filed a claim for refund of that portion of his 1935 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 1942. An adjustment is authorized with respect to the son's tax for 1935.

§ 29.3801 (b)-4 *Correlative deductions and inclusions specified in section 162 (b) and (c) and corresponding provisions of prior Revenue Acts.* 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:

(a) 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.

(b) 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;

(c) 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

(d) 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.

The provisions of (a) of this section may be illustrated as follows:

Example. For the taxable year 1936, 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 1936. In 1938 a State court held invalid the clause directing accumulation. In 1940 the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1936. The claim is sustained by the court in 1942, after the expiration of the period of limitations upon deficiency assessment against the beneficiary for the year 1936. An adjustment is authorized with respect to the beneficiary's tax for the year 1936.

The provisions of (b) of this section may be illustrated as follows:

Example. Assume the same facts as in the example under (a), 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 1936. The deficiency is sustained by final decision of The Tax Court of the United States in 1942, after the expiration of the period for filing claim for refund on behalf of the trust for 1936. An adjustment is authorized with respect to the trust for the year 1936.

The provisions of (c) of this section may be illustrated as follows:

Example. A trustee claimed in the return for 1936 a deduction for income distributed to the beneficiary. The income was included by the beneficiary in his return for 1936. In 1940 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 1942, after the expiration of the period for filing claims for refund by the beneficiary for 1936. An adjustment is authorized with respect to the beneficiary's tax for the year 1936.

The provisions of (d) of this section may be illustrated as follows:

Example. Assume the same facts as in the example under (c), except that, instead of the Commissioner's asserting a deficiency, the beneficiary files a refund claim for 1936 on the same ground. The claim is sustained by the court in 1942, after the expiration of the period of limitations upon deficiency assessments against the trust for 1936. An adjustment is authorized with respect to the trust for the year 1936.

§ 29.3801 (b)-5 *Determination of basis of property in case of erroneous treatment of transaction relating to acquisition thereof.* 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 (1) the original transferee, or (2) a subsequent transferee of such original transferee.

Example (1). In 1936 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 1936 taxpayer A treated the exchange as

one in which gain or loss was not recognizable;

(a) In 1942 the X Corporation claims that gain should have been recognized on the exchange in 1936 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 1936, 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 1936. 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 1936, but, rather, to the property which he transferred in such exchange.

(b) In 1942 the X Corporation transfers the property to the Y Corporation in a tax-free exchange. In 1943 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 (a).

(c) In 1944 taxpayer A sells the stock which he had received in 1936 and claims that, as gain should have been recognized on the exchange in 1936, 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 1936, as the basis for computing gain on the sale depends upon the transaction in 1936 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.

(*d*) 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 1936, as the basis for computing gain on the sale by taxpayer B depends upon the transaction in 1936 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 1937 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1937 taxpayer A failed to include the profit on such sale. In 1942 taxpayer B sells the property for $12,000 and in his return for 1942 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 1937, 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 1937, but rather to property which he transferred in such transaction.

Example (3). In 1936 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 1942, after the expiration of the period of limitations on deficiency assessments for 1936, he sells the stock for $15,000 and reports $5,000 in his return for 1942 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 1936 in that the property then had a fair market valuation of $10,000. An adjustment is authorized with respect to the year 1936.

Example (4). In 1933 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 1933 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 1934 and in his return for that year treated such shares as having a $6,000 basis. In 1939 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 1939. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1933 and 1934, the Commissioner asserts a deficiency for 1939 on the ground that the loss realized on the exchange in 1933 was erroneously treated as nonrecognizable, and that the basis for computing gain upon the sale in 1939 is $2,500, resulting in a gain of $5,000. The deficiency is sustained by The Tax Court in 1943. An adjustment is authorized with respect to the year 1933 as to the entire $7,000 loss realized on the exchange. No adjustment is authorized with respect to the year 1934 as the basis for computing gain upon the sale of the 50 shares in 1939 does not depend upon the transaction in 1934.

§ 29.3801 (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, ommission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 3801.

§ 29.3801 (b)-7 *Operation dependent upon maintenance of inconsistent position*—(a) *Adjustments resulting in additional assessments.* An adjustment which would result in an additional assessment is authorized only if (1) 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 (2) such inconsistent position is adopted in the determination.

Example (1). A taxpayer in his return for 1937 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1938 and after the period of limitations upon the assessment of a deficiency for 1937 had expired, it was discovered that the loss actually occurred in 1938. The taxpayer, therefore, filed a claim for refund for the year 1938 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1942. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1937 by filing a claim for refund for 1938 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 1937.

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 (2). In example (1) above, assume that the taxpayer did not file a claim for refund for 1938 but the Commissioner issued a notice of deficiency for 1938 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 1937. The Tax Court took the deduction into account in its redetermination in 1942 of the tax for the year 1938. In such case no adjustment would be authorized for the year 1937 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.* An adjustment which would result in the allowance of a refund or credit is authorized only if (1) 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 (2) such inconsistent position is adopted in the determination.

Example (1). A taxpayer who keeps his books on the cash basis erroneously included in his return for 1936 an item of accrued interest. After the period of limitations on refunds for 1936 had expired, the Commissioner asserted a deficiency for the year 1937 on the ground that the item of interest was received in 1937, and, therefore, was properly includible in gross income for that year. The taxpayer appealed to The Tax Court, which in 1942 sustained the deficiency. By asserting a deficiency for 1937 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 1936. As the determination—the decision of The Tax Court sustaining the deficiency—adopted such inconsistent position, an adjustment is authorized for the year 1936.

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 (2). In example (1) above, assume that the Commissioner asserted a deficiency for 1937 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 1937. The Tax Court in 1942 included the item of interest in its redetermination of the tax for the year 1937. In such case no adjustment would be authorized for 1936 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.

§ 29.3801 (b)-8 *Existence of status of related taxpayer at time of the first maintenance of an inconsistent position.* 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.

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.

[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.

§ 29.3801 (c)-1 *Method of adjustment.* 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.

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).

[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 (1) the tax shown by the taxpayer, with respect to whom the error was made, upon his return for such taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer upon his return, or if no return was made by such taxpayer, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. 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.

§ 29.3801 (d)-1 *Ascertainment of amount of adjustment.* The amount of the adjustment shall be ascertained as follows:

(a) 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, must first be ascertained. This 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 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, or otherwise repaid in respect of such tax.

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.

(b) 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.

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.

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.

Example. For the taxable year 1936 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return disclosing 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 $5,294.12 on account thereof, representing the maximum deduction allowable under the 15 percent limitation imposed by section 23 (o), Revenue Act of 1936. 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 $3,565, 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 1936, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1937 and asserted a deficiency for that year. As a result of a final decision of The Tax Court of the United States in 1942 sustaining the deficiency for 1937, and adjustment is authorized for the year 1936. The amount of the adjustment is computed as follows:

Tax previously determined for 1936	$3,565.00
Net income for 1936 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	2,646.50
Tax previously determined	3,565.00
Difference	918.50
Amount of adjustment to be refunded or credited	918.50

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.

[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.

§ 29.3801 (e)-1 *Effect of other items on amount of adjustment.* 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.

Example (1). In the example set forth in § 29.3801 (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 1936; 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 1943 an item which should have been included in gross income for the year 1942. After expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1942 the taxpayer filed a claim for refund for the year 1943 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 1942. 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 1942; nor could The Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1942 resulting from the failure to take such deduction.

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 (3). In the example set forth in § 29.3801 (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 1936, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

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 (4). In example (2) above, 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 1942.

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.

[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.

In pursuance of the Internal Revenue Code, as amended, the foregoing regulations are hereby prescribed for taxable years beginning after December 31, 1941, and Regulations 103, as amended,[1] insofar as they relate to income taxes for taxable years beginning after December 31, 1941, are hereby superseded.

[SEAL] ROBERT E. HANNEGAN,
Commissioner of Internal Revenue.

Approved: October 26, 1943.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

[F. R. Doc. 43-17458; Filed, October 23, 1943; 9:43 a. m.]

Chapter VIII—Office of Economic Warfare; Foreign Economic Administration

Subchapter B—Export Control

[Amdt. 116]

PART 802—GENERAL LICENSES

GENERAL IN TRANSIT LICENSES

§ 802.9 *General in transit licenses* is hereby amended in the following particulars:

I. Paragraph (a) *Definitions* is amended to read as follows:

(a) *Definitions.* When used in this section:

(1) "In transit shipment" shall mean a shipment of a commodity or commodities from one foreign destination to another foreign destination, via the United States, for which no formal or informal consumption entry has been made at a United States custom-house.

(2) "S Countries" shall mean the following: French West Africa, French North Africa, Argentina, Eire, Portugal, Portuguese Atlantic Islands, Portuguese Guinea, Spain, Spanish Atlantic Islands, Spanish and International Morocco and Tangier, Sweden, Switzerland, and Turkey.

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[1] Part 19 of this chapter.