Washington, Friday, February 10, 1939

The President

CLOSED AREA UNDER THE MIGRATORY BIRD TREATY ACT—LOUISIANA

BY THE PRESIDENT OF THE UNITED STATES OF AMERICA

A PROCLAMATION

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

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

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

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

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

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

FRANKLIN D. ROOSEVELT

The President

[Seal]

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

FRANKLIN D. ROOSEVELT

By the President:

CORDELL HULL

Secretary of State.

[No. 2322]

[F. R. Doc. 39-476; Filed, February 9, 1939; 12:31 p.m.]

Rules, Regulations, Orders

TITLE 10—ARMY

WAR DEPARTMENT

CHAPTER I—AID OF CIVIL AUTHORITIES AND PUBLIC RELATIONS

PART 7—MANUFACTURE OF DECORATIONS * 2 *

Sec. 7.01. General. Under the authority contained in the act of February 24, 1923 (42 Stat. 1228), as amended by act April 21, 1928 (45 Stat. 437); 10 U. S. C. 1425; The Adjutant General, by authority of the Secretary of War under regulations hereinafter prescribed, will grant certificates of authority to private individuals, firms, and corporations for the sale or the manufacture and sale of service medals, service ribbons, miniatures, miniature oak-leaf clusters, bronze stars, lapel buttons, badges, War Department General Staff Identification, and similar articles covered by the act. * 2

Sec. 7.02. Decorations may not be manufactured or sold. No authority will be granted to any private individual, firm, or corporation to sell or to manufacture and sell the Congressional Medal of Honor, the Distinguished-Service Cross, the Distinguished-Service Medal, the Silver Star, the Purple Heart, the Soldier’s Medal, the Distinguished-Flying Cross, the Army Commendation Medal, the Purple Heart, the Soldier’s Medal, the Distinguished-Flying Cross, and similar articles covered by the act. * 2

CONTENTS

THE PRESIDENT

Proclamation:

Louisiana, closed area under Migratory Bird Treaty Act of 1918: 611

RULES, REGULATIONS, ORDERS

Title 10—Army:

War Department:

Decorations, manufacture of: 611

Military reservations, real estate leases: 613

Title 24—Housing Credit:

Home Owners’ Loan Corporation:

Borrower’s settlement agent: 615

Insurance: Reinstatement after loss: 614

Legal: Settlement of claims; sales contracts: 615

Loan service: Payment of taxes: 614

Property management: Appointment of deputies: 613

Reconditioning:

Execution of reconditioning contracts and forms; awarding of supplemental contracts: 614

Master specifications: 615

Procedure in connection with awarding extras and credits: 613

Title 26—Internal Revenue:

Bureau of Internal Revenue:

Income tax under the Revenue Act of 1938 (Regulations 101):

Table of contents: 616

Chapter I—Scope of regulations: 623

Chapter II—Rates of tax: 623

Chapter III—Gross income; net income: 628

Chapter IV—Deductions from gross income: 638

Chapter V—Credits against income: 662

Chapter VI—Credits against tax: 674

(Continued on next page)

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INTRODUCTORY

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

The main body of these regulations deals with Titles I, IA, and VI of that Act. Chapters of the Act found in Titles III and V and regulations interpreting thereof have been inserted in the Appendix, for example, section 220, relating to mitigation of effect of limitation and other provisions in income tax cases, and section 602, relating to the excess-profits tax. In addition, certain general provisions of prior Acts, and the regulations issued thereunder, which are applicable to the income taxes imposed by the Revenue Act of 1938, have been inserted in the Appendix. The text immediately preceding the Appendix shows the scope and nature of the material included therein.

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

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

CONTENTS

Chapter I
Scope of Regulations

Title 1—Income Tax, Subtitle A—Introductory Provisions

The section numbers refer to the Revenue Act of 1938 and the article numbers to Regulations.

Section 23 (d)-1. Tax on bank or other stock.
Section 23 (e)-1. Losses by individuals.
Section 23 (e)-2. Voluntary removal of building.
Section 23 (e)-3. Loss of useful value.
Section 23 (e)-4. Shrinkage in value of stock.
Section 23 (e)-5. Losses of farmers.
Section 23 (f)-1. Losses by corporations.
Section 23 (g)-1. Capital losses.
Section 23 (h)-1. Deduction of depletion of mines.

Section 23 (m)-1. Depletion of mines, oil or gas wells.
Section 23 (m)-2. Determination of depletion allowance.
Section 23 (m)-3. Determination of depletion allowance.
Section 23 (m)-4. Computation of depletion allowance.
Section 23 (m)-5. Computation of depletion allowance.
Section 23 (m)-6. Determination of cost of deposits.

Section 23 (m)-7. Determination of fair market value of mineral properties, including oil and gas properties.
Section 23 (m)-8. Retention of mineral properties not allowed.
Section 23 (m)-9. Determination of depletion allowances.
Section 23 (m)-10. Depletion of Adjustments of accounts based on book value or adjusted royalty.
Section 23 (m)-11. Depletion and depreciation allowance on books.
Section 23 (m)-12. Statement to be attached to return when valuation, depletion or depreciation of mine or property is claimed.
Section 23 (m)-13. Statement to be attached to return when depletion is claimed on percentage basis.
Section 23 (m)-14. Discovery of mines other than coal, metal, or sulphur mines.
Section 23 (m)-15. Allowable capital additions in case of mines.
Section 23 (m)-16. Charges to capital and to expense in the case of oil and gas wells.
Section 23 (m)-17. Depreciation in the case of mines.
Section 23 (m)-18. Depreciation of improvements in the case of oil and gas wells.
Section 23 (m)-19. Depreciation and depletion of oil and gas wells in years before October 1, 1916.
Section 23 (m)-20. Capital recoverable through depletion allowance or similar obligations.
Section 23 (m)-21. Computation of allowance for depletion of timber for given year.
Section 23 (m)-22. Revaluation of timber not allowed.
Section 23 (m)-23. Computation of improvements in the case of timber.
Section 23 (m)-24. Information to be furnished to the taxpayer claiming depletion of timber.
Section 23 (m)-25. Discovery of fair market value of timber.
Section 23 (m)-26. Determination of quantity of timber.
Section 23 (m)-27. Appreciation of timber and valuation and accounting purposes.
Section 23 (m)-28. Timber depletion and depletion accounts on books.

Section 23 (o)-1. Contributions or gifts by individuals.
Section 23 (p)-1. Payments to employees in employment trusts.
Section 23 (q)-1. Contributions or gifts by corporations.
Section 23 (t)-1. Items not deductible.

Section 24-1. Personal and family expenses.
Section 24-2. Capital expenditures.
Section 24-3. Premiums on business insurance.
Section 24-4. Amounts allocable to exempt income, other than interest.
Section 24-5. Losses from sales or exchanges between certain classes of persons.
Section 24-6. Disallowance of deductions for unpaid expenses and interest.
Section 24-7. Life and terminable interests.

Chapter V
Credits Against Income

Section 25. Credits of individual against net income.
Section 25-1. Credits of individual against net income.
Section 25-2. Earned income credit.
Section 25-3. Amount of personal exemption allowable.
Section 25-4. Personal exemption of head of family.
Section 25-5. Personal exemption of married individuals.
Section 25-6. Credit for dependents.
Section 25-7. Credit for dependents who are entitled to personal exemptions.

Section 26. Credits of corporations.
Section 26-1. Credit of corporation for interest on obligations of the United States and its instrumentalities.
Section 26-2. Credit of corporation for net operating loss of preceding year.
Section 26-3. Bank affiliates.

Section 27 (a)-1. Corporation dividends paid credit. Definition in general.
Section 27 (a)-2. Dividends paid credit.
Section 27 (a)-3. Amounts used or irrevocably set aside to pay or to retire indebtedness.
Section 27 (b)-1. Corporation dividends paid credit. Rule of exclusion.
Section 27 (c)-1. Dividend carry-over.
Section 27 (d)-1. Dividends paid for dividend in kind.
Section 27 (e)-1. Corporation dividends paid credit. Dividends in obligations of the corporation.
Section 27 (f)-1. Dividends in obligations of the corporation.
Section 27 (g)-1. Dividends paid credit. Dividends distributed in liquidation.
Section 27 (h)-1. Dividends paid credit. Dividends distributed in liquidation.
Section 27 (i)-1. Preferred dividends.
Section 27 (j)-1. Joint dividend distributions.
Section 27 (k)-1. Dividends paid credit. Rentable distributions.
Section 27 (l)-1. Dividends paid credit. Definitive distributions.

Section 28 (a)-1. Dividends paid credit. Amortization of corporate deficit.
Section 28 (b)-1. Dividends paid credit. Translation of foreign dividends.
Section 28 (c)-1. Dividends paid credit. Dividends paid in foreign currency.
Section 28 (d)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (e)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (f)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (g)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (h)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (i)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (j)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (k)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (l)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (m)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (n)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (o)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (p)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (q)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (r)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (s)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (t)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (u)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (v)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (w)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (x)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (y)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.
Section 28 (z)-1. Dividends paid credit. Dividends paid in consideration of shares in another corporation.

Section 29. Credits of personal holding companies.
Section 29-1. Credit of personal holding company against net income.
Section 29-2. Credit of personal holding company against net income.
Section 29-3. Credit of personal holding company against net income.
Section 29-4. Credit of personal holding company against net income.
Section 29-5. Credit of personal holding company against net income.
Section 29-6. Credit of personal holding company against net income.
Section 29-7. Credit of personal holding company against net income.
Section 29-8. Credit of personal holding company against net income.
Section 29-9. Credit of personal holding company against net income.

Section 30. Credits of insurance companies.
Section 30-1. Credit of insurance company against net income.
Section 30-2. Credit of insurance company against net income.
Section 30-3. Credit of insurance company against net income.
Section 30-4. Credit of insurance company against net income.
Section 30-5. Credit of insurance company against net income.
Section 30-6. Credit of insurance company against net income.
Section 30-7. Credit of insurance company against net income.
Section 30-8. Credit of insurance company against net income.
Section 30-9. Credit of insurance company against net income.

Section 31. Credits of trusts.
Section 31-1. Credit of trust against net income.
Section 31-2. Credit of trust against net income.
Section 31-3. Credit of trust against net income.
Section 31-4. Credit of trust against net income.
Section 31-5. Credit of trust against net income.
Section 31-6. Credit of trust against net income.
Section 31-7. Credit of trust against net income.
Section 31-8. Credit of trust against net income.
Section 31-9. Credit of trust against net income.

Section 32. Credits of other types of entities.
Section 32-1. Credit of other entity against net income.
Section 32-2. Credit of other entity against net income.
Section 32-3. Credit of other entity against net income.
Section 32-4. Credit of other entity against net income.
Section 32-5. Credit of other entity against net income.
Section 32-6. Credit of other entity against net income.
Section 32-7. Credit of other entity against net income.
Section 32-8. Credit of other entity against net income.
Section 32-9. Credit of other entity against net income.
CHAPTER VII
Returns and Payment of Tax
Part V—Returns and Payment of Tax
Section 51. Individual returns.
Article 28-1. Individual returns.
51-1. Form of return.
51-2. Form of return of minor.
51-3. Verification of returns.
51-4. Use of prescribed forms.
Section 52. Corporation returns.
Article 28-2. Corporation returns.
52-1. Returns by receivers.
52-2. Returns by corpora-
Section 112-(c). Recognition of gain or loss:

Article 112 (i)-1. Reorganization with, or without, a tax-free exchange.

Article 112 (i)-2. Involuntary conversions.

Article 112 (f)-2.

Section 112 (e). Recognition of gain or loss:

Section 112 (d). Recognition of gain or loss:

Same—Gain of corporation.

Section 112 (c). Recognition of gain or loss:

Loss from exchanges not solely in kind.

Section 112 (a). Basis of property acquired.

Section 112 (g)-3. Exchanges solely of stock or securities.

Section 112 (g)-1.

Section 112 (f)-1.

Section 112 (j). (a) (14)-i. Property acquired prior to January 1, 1920.

Section 112 (h)-1.

Section 112 (h)-3.

Section 112 (e)-1.

Section 112 (a) (7)-1. Stock or securities acquired in a tax-free exchange.

Section 112 (a) (11)-1. Basis of property acquired during taxable years beginning after December 31, 1937.

Section 112 (a) (12)-1. Property contributed in kind by a partner to a partnership.

Section 112 (a) (13)-2. Readjustment of partnership interests.

Section 112 (a) (13)-1. Basis of property established by Revenue Act of 1924.

Section 112 (a) (10)-1. Stocks or securities acquired in a tax-free exchange.

Section 112 (a) (9)-1. Property acquired as a result of an involuntary conversion.

No. 28—2

Chapter XVI

Losses From Wash Sales

Section 113. Loss from wash sales of stock or securities.

Article 113-1. Losses from wash sales of stock or securities.

Chapter XIX

Income From Sources Within United States

Section 115. Income from sources within the United States.

Article 115-1. Income from sources within the United States.

Article 115-2. Dividends.

Article 115-3. Interest.

Chapter XX

Income From Sources Without United States

Section 115-4. Income from sources without the United States.

Article 115-4. Income from sources without the United States.

Article 115-5. Sale of personal property.

Article 115-6. Deductions in general.

Chapter XXI

Certain Deductions for Charitable and Other Contributions, and Dividends Paid

Section 115-7. Certain deductions for charitable and other contributions.

Section 115-8. Deduction of dividends paid on certain preferred stocks of certain corporations.

Chapter XXII

Credits Against Tax—Supplemental

Section 115-9. Credits against tax.

Supplement C—Credits Against Tax (Supplementary to Subtitle B, Part III)

Section 131. Taxes of foreign countries and possessions of the United States.

Article 131-1. Analysis of credits for taxes.

Article 131-2. Meaning of term "income from sources without the United States."
Section 204 (b). Insurance companies other than life or mutual: Definition of income, etc.

Section 204 (c). Gross income of insurance companies other than life or mutual.

Section 204 (e). Insurance companies other than life or mutual: Deductions allowed.

Section 204 (d). Insurance companies other than life or mutual: Deductions of former corporations.

Section 204 (f). Insurance companies other than life or mutual: Deductions allowed in insurance companies other than life or mutual.

Section 205. Taxes of foreign countries and possessions of United States.

Section 206. Computation of gross income.

Section 207. Mutual insurance companies other than life.

Section 207-1. Tax on mutual insurance companies other than life.

Section 207-2. Gross income of mutual insurance companies other than life.

Section 207-3. Deductions allowed mutual insurance companies other than life insurance companies.

Section 207-4. Required addition to reserve funds of mutual insurance companies (other than life).

Section 207-5. Special deductions allowed mutual marine insurance companies.

Section 207-6. Special deductions allowed mutual marine insurance companies (other than life or marine).

Section 207-7. Returns of mutual insurance companies (other than life).

Chapter XXVII

Nonresident Aliens

Supplement H—Nonresident Alien Individuals

Section 211. Tax on nonresident alien individuals.

Section 211-1. Taxation of aliens in general.

Section 211-2. Definition.

Section 211-3. Alien seamen, when to be regarded as residents.

Section 211-4. Proof of residence of alien.

Section 211-5. Loss of residence by alien.

Section 211-6. Duty of employer to determine status of alien employee.

Section 211-7. Taxation of nonresident alien individuals.

Section 212. Gross income.

Section 212-1. Gross income of nonresident alien individuals.

Section 212-2. Exclusion of earnings of foreign ships from gross income.

Section 213. Deductions.

Section 213-1. Deductions allowed nonresident alien individuals.

Section 214. Credits against net income.

Section 214-1. Credits to nonresident alien individuals.

Section 215. Allowance of deductions and credits.

Section 215-1. Allowance of deductions and credits to nonresident alien individuals.

Section 216. Credits against tax.

Section 217. Returns.

Section 217-1. Time and place for filing returns of nonresident alien individuals.

Section 217-2. Return of income.

Section 218. Payment of tax.

Section 218-1. Date on which tax shall be paid by nonresident alien individual.

Section 219. Partnerships.

Section 219-1. Partnerships.
CHAPTER XXVII
Foreign Corporations

Supplement I—Foreign Corporations


231-3. Exclusion of earnings of foreign ships from gross income.


CHAPTER XXVIII
Income from Sources Within Possessions of United States

Supplement J—Possessions of the United States

Section 251. Income from sources within possessions of United States. Article 251-1. Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States.

251-2. Income received within the United States.


251-5. Deductions allowed citizens and domestic corporations entitled to the benefits of Section 251.


CHAPTER XXIX
China Trade Act Corporations

Supplement K—China Trade Act Corporations

Section 261. Taxation in general. Article 262-1. Taxation in general.

262-2. Credit against net income. Article 262-3. Credits against the tax.

Section 263. Credit against net income. Article 263-1. Income of shareholders.

Article 263-2. Income of shareholders.

263-2. Credits allowed China Trade Act corporations.

263-3. Limitations of terms used in connection with China Trade Act corporations.


CHAPTER XXX
Assessment and Collection of Deficiencies

Supplement L—Assessment and Collection of Deficiencies


272-3. Extension of time for payment of a deficiency.


Article 274. Bankruptcy and receiverships.


Section 276. Revivals. Article 276-1. Revivals.

Section 277. Suspension of running of statute. Article 277-1. Period of limitation upon collection of tax.

CHAPTER XXXI
Interest and Additions to Tax

Supplement M—Interest and Additions to Tax

Section 291. Failure to file return. Article 291-1. Addition to the tax in case of failure to file return.

Section 292. Interest on deficiencies. Article 292-1. Additions to the tax in case of deficiency.

Section 293. Additions to the tax in case of nonpayment. Article 293-1. Time extended for payment of tax shown on return.

293-2. Time extended for payment of deficiency.

293-3. Interest in case of jeopardy assessments.

Section 294. Additions to the tax in case of nonpayment. Article 294-1. Time extended for payment of tax shown on return.


Section 296. Time extended for payment of tax. Article 296-1. Time extended for payment of tax.

Section 297. Failure to file return. Article 297-1. Failure to file return.

Section 301. Overpayments. Article 301-1. Overpayments.

CHAPTER I
Scope of Regulations

FEDERAL REGISTER, Friday, February 10, 1939

623

be cited as the “Revenue Act of 1938.”


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

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

The articles of these regulations have been given key numbers corresponding to the numbers of the sections, subsections, or paragraphs of the Act. For example, articles 23 (a)–1 to 23 (a)–33, relating to deduction for expenses, bear the key number 23 (a), which corresponds to subsection 23 (a) of the Act. The articles bearing a given key number are the regulations prescribed with respect to the corresponding section, subsection, or paragraph of the Act; and the section, subsection, or paragraph of the Act shall be considered as a part of the respective articles to which it corresponds.

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

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

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

Art. 3–1. Division of regulations.—These regulations have been divided into 38 chapters. Chapter I relates to Introductory Provisions, Subtitle A of Title I. Chapters II to IX relate to General Provisions, Subtitle B of Title I. Chapters X to XXI relate to Subparts A to D of Supplemental Provisions, Subtitle C of Title I. Chapters XXII to XXIX relate to Supplements E to K of Supplemental Provisions, Subtitle C of Title I. Chapters XXX to XXXV relate to Supplements L to P of Supplemental Provisions, Subtitle C of Title I. Chapter XXXVI relates to Title IA, Surtax on Personal

Holding Companies. Chapter XXXVII relates to Title VI, General Provisions of the Act.

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

(a) Estates and trusts and the beneficiaries thereof.—Supplement F.

(b) Members of partnerships.—Supplement F.

(c) Insurance companies.—Supplement G.

(d) Nonresident alien individuals.—Supplement J.

(e) Foreign corporations.—Supplement L.

(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, deriving a large portion of their income from sources within a possession of the United States.—Supplement E.

(h) China Trade Act corporations.—Supplement F.

(i) Foreign personal holding companies and their shareholders.—Supplement F.

(j) Mutual investment companies.—Supplement Q.

Art. 4–1. Application of regulations to Special classes of taxpayers.—With respect to certain classes of taxpayers, the application of the provisions of Chapters II to XXIX of this title shall apply only to the income derived from sources within the United States and in respect to the corresponding section, subsection, or paragraph of the Act; and the section, subsection, or paragraph of the Act shall be considered as a part of the respective articles to which it corresponds.

Sec. 5. Cross references.—The cross references in the title to other portions of the title, where the word “see” is used, are made only for convenience, and shall be given no legal effect.

Sec. 6. Classification of provisions.—The provisions of this title are herein classified and designated as—

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

Art. 3–1. Division of regulations.—These regulations have been divided into 38 chapters. Chapter I relates to Introductory Provisions, Subtitle A of Title I. Chapters II to IX relate to General Provisions, Subtitle B of Title I. Chapters X to XXI relate to Subparts A to D of Supplemental Provisions, Subtitle C of Title I. Chapters XXII to XXIX relate to Supplements E to K of Supplemental Provisions, Subtitle C of Title I. Chapters XXX to XXXV relate to Supplements L to P of Supplemental Provisions, Subtitle C of Title I. Chapter XXXVI relates to Title IA, Surtax on Personal

Holding Companies. Chapter XXXVII relates to Title VI, General Provisions of the Act.
Sec. 12. Surtax on individuals.—(a) Definition of income. — In this section the term "surtax net income" means the amount of the net income in excess of $80,000 and not in excess of $100,000, $55 per centum in excess of $100,000, and upon surtax net incomes in excess of $500,000, 55 per centum in excess of such excess.

(b) Rates of surtax. — There shall be levied, collected, and assessed in respect of surtax net income, a tax on the surtax net income of every individual of such excess as follows:

Upon a surtax net income of $56,000 and upon surtax net incomes in excess of $56,000 and not in excess of $68,000, 31 per centum in addition of such excess.

Upon surtax net incomes of $68,000 and upon surtax net incomes in excess of $68,000 and not in excess of $74,000, 35 per centum in addition of such excess.

Upon surtax net incomes of $74,000 and upon surtax net incomes in excess of $74,000 and not in excess of $80,000, 39 per centum in addition of such excess.

Upon surtax net incomes of $80,000 and upon surtax net incomes in excess of $80,000 and not in excess of $90,000, 41 per centum in addition of such excess.

Upon surtax net incomes of $90,000 and upon surtax net incomes in excess of $90,000 and not in excess of $100,000, 45 per centum in addition of such excess.

The surtax for any amount of surtax net income not stated in round figures in the table is computed by adding to the surtax for the largest amount stated which is less than the surtax net income, the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax due for taxable years beginning after December 31, 1937, upon a surtax net income of $25,128 would be $12,059.92, computed as follows:

Surtax on $25,000 from table .... $11,660.00 Surtax on $1,128 at 39 percent ... 430.01 Total ... 12,090.92

Sec. 13. Tax on corporations in general.—

(a) Adjusted net income.—For the purposes of this title the term "adjusted net income" means the net income of every corporation, the total surtax on a surtax net income of every individual resident and nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a) of the Code, which is the sum of—

(1) The total surtax on any surtax net income of every resident individual in excess of $80,000, $55 per centum in excess of $100,000, and upon surtax net incomes in excess of $500,000, 55 per centum in excess of such excess.

(2) The total surtax on any surtax net income of every nonresident alien individual in excess of $100,000, 39 per centum in excess of such excess.

(3) The total surtax on any surtax net income of every corporation in excess of $100,000, 25 per centum in excess of such excess.

(b) Imposition of tax.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation the tax imposed by subsection (a) of this section, whichever tax is the less, except a corporation subject to the tax imposed by section 14, section 27, or paragraphs (g) and (h) of section 23 of the Code, and any corporation subject to the tax imposed by section 14, section 23 (a), Supplement G, or Supplement H.

The tax computed under subsection (a) of this section, whichever tax is the lesser, shall be the tax computed under subsection (b) of this section.
no portion of the gross income consists of interest allowed as a credit by section 26 (a) (relating to certain obligations of the United States and Government corporations), or of dividends of the class with respect to which credit is allowed by section 26 (b), the tax computed under this subsection shall be equal to $3,350, plus 21 per centum of the excess of the net income in excess of $25,000.

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

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

(B) To the first division shall be allocated, until an aggregate of $3,350 has been so allocated: First, the portion of the gross income consisting of such interest; second, the portion of the gross income consisting of such dividends; and third, an amount equal to the excess, if any, of $25,000 over the amounts already allocated to the first division.

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

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

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

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

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

(e) Corporations in bankruptcy and receivership.—If a domestic corporation is for any portion of the taxable year in bankruptcy under the laws of the United States, or insolvency in a court of the United States or of any State, Territory, or the District of Columbia, then, when the tax for the corporation is computed under section 26 (b), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit.

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

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

(h) Exempt corporations.—For corporations exempt from taxation under this title, see section 13.

(i) Tax on personal holding companies.—For surtax on personal holding companies, see Title 21.

(j) Improper accumulation of surplus.—For surtax on corporations which accumulate earnings and profits in a manner improper, see chapter 142, section 102.

Art. 13-1. Tax on corporations in general.—Section 13 imposes an income tax on corporations on the net income of which is more than $25,000. Every such corporation is liable to the tax imposed by that section, except (1) corporations expressly exempt from taxation under Title I (see section 101); (2) corporations subject to tax under section 14, being (A) corporations having incomes of not more than $25,000, (B) banks, as defined in section 104, (2) corporations organized under the China Trade Act, 1922, (D) corporations which by reason of deriving a large portion of their gross income from sources within a possession of the United States are entitled to the benefit of section 284, and (E) foreign corporations; (2) insurance companies (see Supplement G); and (4) mutual investment companies (see Supplement Q).

It makes no difference that a domestic corporation subject to any tax imposed by section 13 may derive no income from sources within the United States. The tax imposed by section 13 is computed upon the "adjusted net income," that is, the net income as defined in section 21 minus the credit provided in section 28 (a), relating to interest on certain obligations of the United States and its instrumentalities. The term "adjusted net income" is used elsewhere in the regulations under Title I and where so used has the meaning here given to it.

The tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 239). For what term "corporation" includes and for the difference between domestic and foreign corporations, see section 501. For surtax on personal holding companies, see Title IA. For surtax on corporations improperly accumulating surplus, see section 102. For the duration of the operation of section 13, see section 15.

The tax imposed shall be computed under subsection (c) (the general rule) or subsection (d) (the alternative tax) of section 13, whichever computation produces the lesser tax. Subsection (d) is designed primarily for corporations having net incomes of more than $25,000. In the case of such corporations, subsection (d) will frequently produce a lesser tax, although the result in any given case depends upon the facts and figures involved (see article 13-3). See article 13-2. The application of the general rule set out in subsection (c) of section 13 may be illustrated by the following examples:

Example: The A Corporation, a domestic corporation, which is not a bank, is liable to the tax under Title I. The corporation pays to its shareholders, during the taxable year, $30,000 in dividends. It is not entitled to any dividend carry-over under section 27. Its tax for the calendar year 1938 is $17,097.50, computed as follows:

**Computation of Tax**

**Tentative tax:**

Net income: $110,000

Less credit for interest on United States obligations: $10,000

Adjusted net income: $100,000

**Tentative tax under section 13:**

(c) (19 percent of $100,000) $19,000.00

Credit for dividends received and dividends paid:

(1) Dividends received (85 percent of $10,000) $8,500.00

(2) Dividends paid $2,000.00

Total credit (section 13 (c) (2)) $10,500.00

Total tax: $17,097.50

Art. 13-3. Alternative tax (corporations with net incomes slightly more than $25,000).—Section 13 provides an alternative method for computing the tax in the case of corporations having net incomes of slightly more than $25,000. If no portion of the gross income consists of interest on obligations of the United States and its instrumentalities allowable as a.
credit under section 26 (a), or of dividends of the class with respect to which the credit is allowable under section 26 (b), the alternative tax is equal to $3,525 plus 32 percent of the amount of the net income in excess of $25,000. If any portion of the gross-income consists of interest, dividends, or both, and if referred to in the preceding sentence, it is necessary, in order to determine the amount of net income subject to tax and the rate of tax applicable thereto, first to divide the income into two parts, or divisions, the first consisting of $25,000 and the second consisting of the balance of the net income in excess of $25,000.

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

Example (1): The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1938 a net income of $34,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $15,000 and dividends amounting to $13,000 (allowable as a credit under section 26 (b)). It is not entitled to a dividends paid credit under section 27. Since, as will be herein after appear, the alternative tax is more than the tax computed under the general rule, the correct tax is the tax computed under the general rule, that is, $1,937. The tax is computed as follows:

<table>
<thead>
<tr>
<th>Tax Under General Rule</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$34,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$19,000.00</td>
</tr>
<tr>
<td>Tentative tax (19 percent of $19,000)</td>
<td>$3,610.00</td>
</tr>
<tr>
<td>Less credit for dividends received (16 2/3 percent of $15,000)</td>
<td>$1,682.00</td>
</tr>
<tr>
<td>Total tax under general rule</td>
<td>$1,927.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Alternative Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net income</td>
<td>$34,000.00</td>
</tr>
<tr>
<td>Less net income allocated to first division</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Net income allocated to second division</td>
<td>$9,000.00</td>
</tr>
<tr>
<td>Tax on first division</td>
<td></td>
</tr>
<tr>
<td>Total net income</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Less credit for dividends received (16 2/3 percent of $10,000)</td>
<td>$8,500.00</td>
</tr>
<tr>
<td>Special class net income (section 14 (a))</td>
<td>$1,500.00</td>
</tr>
<tr>
<td>Tax under section 14 (12 1/2 percent of $1,500)</td>
<td>$187.50</td>
</tr>
<tr>
<td>Tax on second division</td>
<td></td>
</tr>
<tr>
<td>Total income allocated to second division</td>
<td>$9,000.00</td>
</tr>
<tr>
<td>Less dividends allocated to second division</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$7,000.00</td>
</tr>
<tr>
<td>Tax (12 percent of $7,000)</td>
<td>$840.00</td>
</tr>
<tr>
<td>(32 percent of $7,000)</td>
<td>$2,280.00</td>
</tr>
<tr>
<td>Total tax on second division</td>
<td>$3,120.00</td>
</tr>
<tr>
<td>Total alternative tax</td>
<td>$3,307.50</td>
</tr>
</tbody>
</table>

Example (2): The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1938 a net income of $37,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $25,000 and dividends amounting to $12,000 (allowable as a credit under section 26 (b)). It paid dividends during the year in the amount of $12,000. It is not entitled to any dividend carry-over under section 27. Since the alternative tax is less than the tax computed under the general rule, the correct tax is the alternative tax, that is, $2,955. The tax is computed as follows:

<table>
<thead>
<tr>
<th>Alternative Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net income</td>
<td>$37,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$22,000.00</td>
</tr>
<tr>
<td>Less credit for dividends received (20 percent of $12,000)</td>
<td>$2,400.00</td>
</tr>
<tr>
<td>Special class net income (section 14 (a))</td>
<td>$825.00</td>
</tr>
<tr>
<td>Tax under section 14 (12 1/2 percent of $825)</td>
<td>$103.13</td>
</tr>
<tr>
<td>Tax on first division</td>
<td></td>
</tr>
<tr>
<td>Total net income</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Less credit for dividends received (16 2/3 percent of $10,000)</td>
<td>$8,500.00</td>
</tr>
<tr>
<td>Special class net income (section 14 (a))</td>
<td>$1,500.00</td>
</tr>
<tr>
<td>Tax under section 14 (12 1/2 percent of $1,500)</td>
<td>$187.50</td>
</tr>
<tr>
<td>Tax on second division</td>
<td></td>
</tr>
<tr>
<td>Total income allocated to second division</td>
<td>$12,000.00</td>
</tr>
<tr>
<td>Less dividends allocated to second division</td>
<td>$2,400.00</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$9,600.00</td>
</tr>
<tr>
<td>Tax (12 percent of $9,600)</td>
<td>$1,152.00</td>
</tr>
<tr>
<td>(32 percent of $9,600)</td>
<td>$3,072.00</td>
</tr>
<tr>
<td>Total tax on second division</td>
<td>$4,224.00</td>
</tr>
<tr>
<td>Total alternative tax</td>
<td>$5,181.53</td>
</tr>
</tbody>
</table>

Example (3): The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1938 a net income of $37,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $15,000 and dividends amounting to $12,000 (allowable as a credit under section 26 (b)). It paid dividends during the year in the amount of $12,000. It is not entitled to any dividend carry-over under section 27. Since the alternative tax is less than the tax computed under the general rule, the correct tax is the alternative tax, that is, $2,955. The tax is computed as follows:

<table>
<thead>
<tr>
<th>Alternative Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net income</td>
<td>$37,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$22,000.00</td>
</tr>
<tr>
<td>Less credit for dividends received (20 percent of $12,000)</td>
<td>$2,400.00</td>
</tr>
<tr>
<td>Special class net income (section 14 (a))</td>
<td>$825.00</td>
</tr>
<tr>
<td>Tax under section 14 (12 1/2 percent of $825)</td>
<td>$103.13</td>
</tr>
<tr>
<td>Tax on first division</td>
<td></td>
</tr>
<tr>
<td>Total net income</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Less interest on United States obligations</td>
<td>$15,000.00</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Less credit for dividends received (16 2/3 percent of $10,000)</td>
<td>$8,500.00</td>
</tr>
<tr>
<td>Special class net income (section 14 (a))</td>
<td>$1,500.00</td>
</tr>
<tr>
<td>Tax under section 14 (12 1/2 percent of $1,500)</td>
<td>$187.50</td>
</tr>
<tr>
<td>Tax on second division</td>
<td></td>
</tr>
<tr>
<td>Total income allocated to second division</td>
<td>$12,000.00</td>
</tr>
<tr>
<td>Less dividends allocated to second division</td>
<td>$2,400.00</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$9,600.00</td>
</tr>
<tr>
<td>Tax (12 percent of $9,600)</td>
<td>$1,152.00</td>
</tr>
<tr>
<td>(32 percent of $9,600)</td>
<td>$3,072.00</td>
</tr>
<tr>
<td>Total tax on second division</td>
<td>$4,224.00</td>
</tr>
<tr>
<td>Total alternative tax</td>
<td>$5,181.53</td>
</tr>
</tbody>
</table>
rupt, if a petition for reorganization of the corporation has been filed by the corporation and has been approved by the court having jurisdiction thereof, or if the corporation has filed a petition for an arrangement of its indebtedness under Chapter XI of the Act in a court having jurisdiction thereof. In such cases, the provisions of subsection (e) of section 13, allowing a credit of 21/2 percent of the adjusted net income, in lieu of the credit on account of dividends paid, shall not apply to—

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

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

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

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

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

(2) if no trustee has been appointed, are retained by the debtor corporation, free and clear of all claims of the debtor corporation, its shareholders and creditors, except such claims as may consistently with the plan be reserved in the order confirming the plan or directing the transfer and conveyance or retention of such properties.

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

Any corporation claiming the credit under subsection (e), (f), or (g) of section 13, that is, seeking to reduce the tentative tax by 2 1/2 percent of the adjusted net income, instead of by 2 1/2 percent of the dividends paid credit, shall file as a part of its return for each taxable year for which such credit is claimed a statement under oath of all facts pertinent to its claim.

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

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

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

Upon special class net incomes not in excess of $8,000, 1/2 per centum.

Upon special class net incomes of $8,000 and upon special class net incomes in excess of $8,000 and not in excess of $25,000, 12 1/2 per centum in addition of such excess.

Upon special class net incomes of $25,000, 14 per centum in addition of such excess.

(d) Special classes of corporations.—In the case of the following corporations the tax shall be as provided in section 26 (d), in lieu of the tax on special class net income, of the special class net income, regardless of the amount thereof:

(1) Banks, as defined in section 104.

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

(3) Corporations which, by reason of dealing in a large portion of their gross incomes from sources within a possession of the United States, are entitled to the benefits of section 29.

(4) Foreign corporations.—(1) In the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein, the tax shall be an amount equal to 10 per centum of the special class net income, regardless of the amount thereof.

(2) In the case of a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, the tax shall be as provided in section 241 (b).

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

(f) Holding companies.—In the case of mutual investment companies, as defined in Supplement G, the tax shall be provided in such Supplement.

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

(i) Tax on personal holding companies.—For surtax on personal holding companies, see Title 1A.

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

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

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

As in the case of corporations subject to the tax under section 13, it makes no difference that a domestic corporation subject to any tax imposed by section 14 may derive no income from sources within the United States. So also, the tax is payable upon the basis of returns rendered by the corporations liable therefor, except that in some cases a tax is not to be paid at the source of the income (see sections 41, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 201. For surtax on personal holding companies, see Title 1A. For surtax on corporations improperly accumulating surplus, see section 102. For the duration of the operation of section 14, see section 15.

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

Total net income________________________$24,000
Less interest on United States obligations________________________$9,000
Adjusted net income________________________15,000
Deduct credit under section 26 (b)
(Dividends received of the class allowable as a credit) $5,000
SPECIAL CLASS NET INCOME________________________10,000
Surtax on special class net income
On $5,000 from table on p. 623________________________653
On $5,000 at 14 percent________________________701
Total tax________________________1,430

Subsection (d) of section 14 relates to (1) banks, as defined in section 104, (2) corporations which, under the China Trade Act, 1922, are foreign corporations which, by reason of dealing in a large portion of their gross income from sources within the possession of the United States, are entitled to the benefits of section 291. That subsection imposes an income tax upon such corporations in the amount equal to 16 1/2 percent of the special class net income, regardless of the amount thereof.

Subsection (e) of section 14 provides for a tax on foreign corporations engaged in trade or business within the United States or having an office or place of business therein, equal to 10 percent of the special class net income, regardless of the amount thereof. In the case of foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, the tax is as provided in section 231 (a). In the case of insurance companies, the tax is as provided in Supplement G. In the case of mutual investi-
ment companies, as defined in Supplement Q, the tax is as provided in Supplement Q.

Subsection (c) of section 14 imposes a tax at graduated rates on corporations which do not have net incomes of more than $25,600 and which do not come within one of the classes specified in subsection (d) (special classes of corporations), (e) (foreign corporations), (f) (insurance companies), or (g) (mutual investment companies) of section 14. The tax is the same whether or not the corporation distributes any dividends during the taxable year.

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

### Table of Corporation Income Tax Under Section 14 (c)

<table>
<thead>
<tr>
<th>Special class net income</th>
<th>Percent</th>
<th>Total tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $4,000</td>
<td></td>
<td>$0.25</td>
</tr>
<tr>
<td>$4,000 to $8,000</td>
<td>14</td>
<td>2.725</td>
</tr>
<tr>
<td>$8,000 to $12,000</td>
<td>16</td>
<td>2.525</td>
</tr>
<tr>
<td>$12,000 to $16,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

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

### Chapter III

#### Gross Income—Net Income

Part II—Computation of Net Income

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

Art. 21. Meaning of net income—The tax imposed by Title I is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 22(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 as a return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the Act recognizes determinable factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22,b, 23, 24, and 117.)

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

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

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

The normal taxes and surtaxes imposed upon individuals and 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 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 22, 23, 102, 118, 121, 203, 204, 207, 232, 335, and Title I.)

Sec. 22. Gross income—(a) General definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, or from whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property, from interest, rents, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits derived from any source whatever. In the case of Presidents of the United States and judges and courts of the United States taking office after June 6, 1933, the compensation received as included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

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

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

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

As to insurance companies and foreign corporations, see sections 203, 204, 206, 207, and 231.
sions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, salaries of Federal and other officers, and pensions or retiring allowances paid by private persons or by the United States are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for singing masses for the dead, and other consolations rendered. However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable. The salaries of Federal officers and employees are subject to tax. See article 116-2 as to compensation of State officers and employees.

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

Art. 22 (a)–4. Compensation paid in notes.—Notes or other evidences of indebtedness received in payment for services constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt the face 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 income at 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 such payment so much thereof as represents recovery for the discount originally deducted.

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

Art. 22 (a)–6. State contracts.—The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income.

In the case of a contractor upon conversion of the warrants into cash does not receive and cannot recover the full value of the warrants so returned, he may deduct from gross income for the year in which the warrants are converted into cash any loss sustained, and if he realizes more than the value of the warrants so returned he should include the excess in his gross income for the year in which realized.

Art. 22 (a)–7. Gross income of farmers.—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock or other items which were purchased, and (2) gross income from all other sources. The profit (b) (6) 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. Rent 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. The amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see article 41–2), be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized.

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

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

Art. 22 (a)–9. Sale of stock and rights.—If shares of stock in a corporation are issued 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 such stock prescribed by paragraphs (1), (2), (3), and (4) of section 117 (d) (relating to the period for which property has been held) shall be applied. The excess of the amount realized on the sale over the cost or other basis of the stock will constitute gain. In the case of stock in respect of which was paid a stock dividend which did not constitute income under the Constitution, the basis for determining gain or loss from a sale of either the stock in respect of which the distribution was made or the stock dividend shall be ascertained in accordance with the principles set forth in article 113 (a) (12)–1. If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.

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

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

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

\[
\begin{align*}
500 \text{ (shares)} \times 125 &= 62,500, \text{ cost of old stock} \\
500 \text{ (shares)} \times 120 &= 60,000, \text{ market value of old stock} \\
500 \text{ (rights)} \times 4 &= 2000, \text{ proceeds of sale of rights} \\
\end{align*}
\]

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

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

Example: A taxpayer in 1933 purchased 500 shares of common stock at $125 a share, and in 1933, by reason of the ownership of such stock, received 500 rights giving him the right to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows:

\[
\begin{align*}
500 \text{ (shares)} \times 125 &= 62,500, \text{ cost of old stock} \\
500 \text{ (shares)} \times 120 &= 60,000, \text{ market value of old stock} \\
500 \text{ (rights)} \times 3 &= 1500, \text{ market value of rights} \\
500 \text{ (shares)} \times 125 &= 62,500, \text{ cost of old stock apportioned to rights} \\
61,500 \text{ of } 62,500 &= 60,975.61, \text{ cost of old stock apportioned to rights} \\
500 \text{ (shares)} \times 125 &= 62,500, \text{ cost of old stock apportioned to rights} \\
61,500 \text{ of } 62,500 &= 60,975.61, \text{ cost of old stock apportioned to rights} \\
\end{align*}
\]

$1,524.39 (cost of old stock apportioned to rights) less $1,524.39 (cost of old stock apportioned to rights) = $0, profit.

Example: A taxpayer in 1935 purchased 1,000 shares of common stock at $1,000 a share, and in 1935, by reason of the ownership of such stock, received 1,000 rights giving him the right to subscribe to 200 additional shares of such stock at $500 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $1,000, and the rights had a fair market value of $30 each. The taxpayer exercised his rights to subscribe to 100 additional shares of such stock at $500 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $1,000, and the rights had a fair market value of $30 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $1,250. The profit is computed as follows:

\[
\begin{align*}
1000 \text{ (shares)} \times 1000 &= 1000000, \text{ cost of old stock} \\
1000 \text{ (shares)} \times 1000 &= 1000000, \text{ market value of old stock} \\
1000 \text{ (rights)} \times 30 &= 30000, \text{ proceeds of sale of rights} \\
\end{align*}
\]

$1,500 (proceeds of sale of rights) less $1,000 (cost of old stock apportioned to rights) = $500, profit.

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

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

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

**FEDERAL REGISTER, Friday, February 10, 1939**

363

such lots or parcels which constitutes
parcels of ground to be sold as such, the
cost or other basis shall be equitably ap-
portioned 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 in-
come 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 be-
fore any taxable income shall be re-
turned. The sale of each lot or parcel
will be treated as a separate transaction,
and gain or loss computed accordingly.

**ART. 22 (a)-12. Amortization of in-
"parcels of ground to be sold as such, the
struction, and the so-called "dividend" of
temporary owner of a tract of land, such
is terminated so that the lessee
comes into possession or control of the
property prior to the time originally
fixed for the expiration of the lease, the
lessee shall report income for the year
in which the lease is so terminated to the
extent that the value of such buildings
improvements when he becomes en-
titled to such possession exceeds the
amount already reported as income on
account of such buildings or improvements.
No appreciation in value due to causes other than the ter-
minal of the lease shall be included.

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

**ART. 22 (a)-14. Cancellation of in-
debtedness.—(a) In General.—The can-
cellation of indebtedness, in whole or in
part, may result in the realization of in-
come. If, for example, an individual per-
foms services for a creditor, who in con-
sideration thereof cancels the debt, in-
come in the amount of the debt is real-
ized by the debtor as compensation for
his services. A taxpayer realizes income
by the payment or purchase of his obli-
gations at less than their face value.
(See article 22 (a)-18.) In general, if a
shareholder in a corporation which is in-
debted to him gratuitously forgives the
debt, the transaction amounts to a con-
tribution to the capital of the corpo-
ration to the extent of the principal of the
debt.

(b) Proceedings under Bankruptcy
Act.—Income is not realized by a tax-
payer by virtue of section 77B of the
Bankruptcy Act, as amended, of his indebtedness as the re-
sult 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 reorganiza-
tion 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 Bank-
ruptcy Act, as amended;
- (3) an "arrangement" or a "real
property arrangement" confirmed under
Chapter 12 or 13, respectively, of the
Bankruptcy Act, as amended; or
- (4) a "wage earning plan" confirmed
under Chapter XIII of the Bankruptcy
Act, as amended.

**ART. 22 (a)-15. Creation of sinking
fund by corporation.—If a corporation,
in order solely to secure the payment of
its bonds or other indebtedness, places
property in trust or sets aside certain
amounts in a sinking fund under the
control of a trustee who may be author-
ized 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 there-
from is income of the corporation and
shall be included as such in its gross
income for the year of its origina-

**ART. 22 (a)-16. Acquisition or dispo-
sition by a corporation of its own capital
stock.—Whether the acquisition or dispo-
sition 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 cor-
poration 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 corporation was in existence before
the payment or at the time of its origina-
tion; the 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 if it were dealing in the shares of
another corporation, the resulting gain or
loss is to be computed in the same man-
er as though the corporation were deal-
ing in the shares of another. So also if
the corporation receives its own stock as
consideration upon the sale of property
by it, or in satisfaction of indebtedness
to it, the gain or loss resulting is to be
computed in the same manner as though
the payment had been made in any
other property. Any gain derived from
such transactions is subject to tax, and
any loss sustained is allowable as a de-
duction where permitted by the provi-
sions of the Act.

**ART. 22 (a)-17. Contributions to cor-
porations by shareholders.—If a corpora-
tion requires additional funds for con-
ducting its business and obtains such
money through voluntary pro-
rate payments by its shareholders, the
amounts so received being credited to its surplus account or to a special capital account, such amounts will be considered income. Although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See articles 22 (a)-14 and 24-3.)

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

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

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

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

Art. 22 (b)-1. Exemptions—Exclusions from gross income.—Certain items of income specified in section 22 (b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items may be 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 any Act of Congress not inconsistent with or repealed by the Act; (3) the income exempt under the provisions of section 116. Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the Act to be made from gross income in computing net income. As to other items to be included in gross income, see sections 115 and 119 and Supplements C, H. I., and J.

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

(1) Life insurance.—Amounts received under a life insurance policy by reason of the death of the insured, whether in a single sum or otherwise, are included in the amount of life insurance proceeds paid by the corporation to the policyholder, the proceeds of which are treated as if made from gross income in computing net income. The proceeds of life insurance policies, paid by reason of the death of an insured to any beneficiary (individual, partnership, or corporation, but not a transferee for valuable consideration), directly or in trust, are excluded from the gross income of the beneficiary. While it is immaterial whether the proceeds of a life insurance policy payable upon the death of the insured are paid to the beneficiary in a single sum or in installments, only the amount paid solely by reason of the death of the insured is taxable. The amount exempted is the amount payable to the corporation for the purpose of ascertaining the liability for taxes in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and the receiver or trustee stands in the stead of the corporation for such purposes. (See sections 274 and 286.) Any sales of property by them are to be treated as if made by the corporation for the purpose of realizing 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 (c) and article 44-5. (See further article 52-2.)
the proceeds are held, there is exempted only the amount which the insured had the policy not provided for payment at a later date or dates. Any increment thereto is taxable. In any mode of settlement the portion of each distribution which is to be so included in gross income shall be determined as follows:

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

(b) Proceeds payable in installments for a fixed number of years.—If the proceeds are payable in installments for a fixed number of years 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 were 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 installment received as an installment in excess of $100 is to be included in gross income.

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

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

If a mode of settlement has been in effect prior to the first taxable year which begins after December 31, 1933 (or after December 31, 1935, in the case of a mode of settlement described in paragraph (d) of this article), the entire amount received and excluded from gross income in such prior years shall be deducted from the proceeds payable upon the death of the insured; the remainder shall be divided by the number of instalments of payments to be made, and the quotient shall be the proportion of each installment to be excluded from gross income (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 conclusive portion of each installment. As soon as the aggregate amount of the amounts received and excluded from gross income under the methods of computation provided for in this article equals the amount of the proceeds payable upon the death of the insured, the entire amount received thereafter in each taxable year must be included in gross income.

[Sec. 22. Gross income.]

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

(2) Annuities, etc.—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or an annuity contract, or any interest thereon, whether or not paid during the taxable year, shall be included in gross income. Amounts received as an annuity under an annuity or endowment contract, but if such amounts 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. This provision of this article may be illustrated by the following examples:

Example (1): A bought in 1935, for $50,000, consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1936 he would be required to include in gross income $1,000 of the $5,000 received during that year (3 percent of $50,000), $3,000 being excempt. If A should live long enough to receive as exempt $30,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

Example (2): A bought an annuity on October 31, 1936, paying $20,000 as consideration therefor. The annuity amounted to $7,624 a year, payable in semiannual installments of $3,912, and on December 1, 1938, A received $1,504, the first payment under the contract being for a 2-month period. A shall include in his gross income for the calendar year 1938 the sum of $900, 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 November 1, 1938, paying $5,000 as consideration therefor. The annuity amounted 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, 1939, amounting to $300. He shall include in his gross income for the calendar year 1939 the sum of $250, being such portion of the installment as is not in excess of 3 percent of $40,000 (the con-
sideration paid) divided by 12 and multi-
plicated by 3 (the number of months in re-
spect of which the installment was paid).

[- Sec. 22, Gross income.]

(1) Exclusions from gross income.—The
following items shall be included in gross
income and shall be exempt from tax-
ation under this title:

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

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

[- Sec. 22, Gross income.]

(2) Exclusions from gross income.—The
following items shall not be included in
gross income and shall be exempt from tax-
ation under this title:

(4) Tax-free interest.—Interest upon
the obligations of a State, Territory, or any
political subdivision thereof, or the District
of Columbia; or (B) obligations of a corpo-
ration organized under Act of Congress,
if such corporation is an instrumentality
of the United States, if such corporation is
an Act of Congress, if such corporation is an
instrumentality of the United States, if such
obligation is entirely exempt from tax-
ation, except taxes imposed upon the
income derived therefrom, shall be exempt from taxation, except taxes
upon real estate, and that first mortgages
executed to Federal land banks, Federal
intermediate credit banks, or to joint
stock land banks, and farm-loan bonds,
debentures issued by intermediate
credit banks for cooperatives, and produc-
tion credit corporations, and mort-
ges, or from such farm-loan bonds
debentures, is not subject to the in-
test. However, dividends on the
stock of the central bank for coopera-
tives, the production credit corporations,
production credit associations, and banks
for cooperatives, organized under the
provisions of the Farm Credit Act of
1933, constitute income to the recipients,
subject to both normal tax and surtax.
Dividends on share accounts of Federal
savings and loan associations are exempt
from the normal tax by section
provisions of section 5 (b) of the Home
Owners' Loan Act of 1933 (48 Stat., 133).

Art. 22 (b) (4)–3. Dividends from Fed-
eral reserve banks.—Section 7 of the
Federal Reserve Act of December 23,
1915, provides that Federal reserve
banks, including the capital stock and
income derived therefrom, shall be exempt from tax-
ation, except taxes upon real estate. This
exemption attaches to and follows the
income derived from dividends on stock of Federal reserve banks in the hands of the shareholders, but the divi-
dends received on the stock of Federal reserve banks are not subject to the in-
test. Dividends paid by member
banks, however, are treated like divi-
dends of ordinary corporations.

Art. 22 (b) (4)–4. Interest upon
United States obligations.—Although
interest upon obligations of the United
States and its possessions and upon obli-
gations of a corporation organized under
Act of Congress, if such corporation is an
instrumentality of the United States, is
generally exempt from tax, in the case of obligations
under this title:

Treasury certificates of indebtedness,
Treasury bonds, and Treasury notes, and
in the case of obligations of a corpora-
tion 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 obli-
gations enumerated in clause (A), (B),
or (C) of paragraph (4) of subsection 22
(b) shall submit in his income tax re-
port a statement showing the number
and amount of such obligations owned
and the interest thereon received.
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 there-
from" 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 ex-
tent 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 in-
tcome taxes. With respect to the nonde-
ductibility of losses from the sale or
other disposition of such bills, see article
23 (a)–1.

The interest on Treasury bonds is ex-
empt from Federal income taxes except
surtaxes imposed upon the income or
profits of individuals, partnerships, as-
jociations, or corporations.

Treasury bonds are entitled to a lim-
ited exemption from surtaxes imposed
by the United States. Interest on an
aggregate of not exceeding $5,000 prin-
cipal amount of these obligations is ex-
empt from the surtaxes imposed by the
Act. Interest in excess of the Inter-
est on an aggregate of not exceeding
$5,000 principal amount of such obliga-
tions is subject to surtax and must be
included in gross income.

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

Art. 22 (b) (4)–5. Treasury bond ex-
emption in the case of trusts or partner-
ships.—(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 tax-
able to the trustee, as in the case of a
trust the income of which is accumulated
for the benefit of unborn or unascert-
tained 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 partnership; but the Internal Revenue Code, by its terms, exempts from taxation the income of a partnership which is passing to the purchaser. A purchaser should include in inventory merchandise purchased from a partnership, even if title thereto is vested in the taxpayer, 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.

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

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

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

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

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

(c) 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;
The income of States, municipalities, and other political subdivisions;
Receipts of shipowners' mutual protection and indemnity associations;
Dividends from China Trade Act corporations;
Compensation of employees of foreign governments.

(c) Inventories.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of a 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.

Ann. 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 be kept separate, if possible, and should be taken at a time when the value of all goods and supplies, both those which have been acquired for sale and those which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased from a partnership, even if title thereto is vested in the taxpayer, 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.

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

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

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the accounting practice of 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 valuation. Under this rule, the inventory practice of a taxpayer 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. Any 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 section 22 (c)-5. Any goods in an inventory which are unsalable at normal prices or unsalable in the normal way because of damage, imperfections, storage, wear, changes in style, odd or broken lots, or other similar causes, included in the inventory, 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 partially finished goods hold 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 are valued upon such selling basis within the classifications indicated above, and he shall maintain such records of the disposition of the goods. The value as provided by the verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1929 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. No change shall be made after the close of the taxable year of the date on which permission is given. 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. (See section 22 (d) as to inventories in certain industries. Where the taxpayer maintains book inventories and a computerized invoice 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, the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. This business 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 commonly used in taking or valuing inventories, but are not in accord with these regulations, viz:

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

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

(3) Omitting portions of the stock on hand.

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

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

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

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.
(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discount in the ordinary course of business, less return on capital (including any cost of selling or return on capital, management expenses, but not including 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 return on capital, whether by way of interest or profit.

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

Art. 22 (c)-4. Inventories at cost or market, whichever is lower.—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in 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 markets, 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 compensating paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandises 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 made for such period and in such market, before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

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

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

(a) At cost; or

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

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in article 41-2. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this article, as regularly inventorizing 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 here provided include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

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

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

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

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

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

Because of the difficulty of ascertaining the actual cost of live stock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method," which provides for the valuation of inventories at market price less direct cost of disposition. If
the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner and also from the Secretary. 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 is provided for in article 41-2, under this method the total of the retail selling prices of the goods on hand at the close of the preceding taxable year, or of each class of goods, is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as—

(a) the total of the retail selling prices of goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (c).

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 increase in the value of goods during the year.

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

An election to use such method is authorized, if the Commissioner change to a different method is authorized, and then upon such terms and conditions and in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe.

Sec. 23. Gross income.—

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

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

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

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

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

(B) Not yet included in goods in process or finished goods;

may determine the cost of such materials remaining on hand as being equal to the cost of such materials, treated as the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition.

An exception to this general rule is provided for in section 22 (d), which permits certain specifically described taxpayers to elect to treat certain raw materials remaining on hand at the close of the taxable year as being: first, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition.

No item in an inventory of raw materials to which this method is applied shall be valued at market. All inventories of such raw materials (including the inventory as of the close of the preceding taxable year) shall be taken at cost. The opening inventory of such raw materials on which an election is made shall be brought in at the same cost as the closing inventory of such raw materials for the preceding taxable year.

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

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

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

(3) Tanning hides or skins, or both.

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

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

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

ART. 22 (d)-5. Adjustments to be made by the taxpayer.—A taxpayer may not change to the method of taking inventories provided for in section 22 (d) unless he agrees to and maintains adequate securities, and pays such taxes with respect to such adjustments, in the inventories of prior taxable years or otherwise, as the Commissioner deems necessary to prevent the change in method from resulting in avoidance of tax.
Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)-1 to 23 (g)-1. Double deductions are not permitted. Amounts deducted under one provision of the Act cannot again be deducted under any other provision of the Act. As to charitable contributions by corporations not deductible under section 23 (a), see article 23 (a)-13. 

The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 22 (a)-5.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, and travel expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

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

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

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

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

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

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

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

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

Art. 23 (a)-4. Repairs. - The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expenses provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See articles 23 (0)-1 to 23 (0)-10.)

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

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

(1) Any amount paid in the form of compensation, but not in fact as the purchase of services, is not deductible.

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

This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the active management of the enterprise. In such case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation 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 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 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 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.
(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Art. 23 (a)–7. Treatment of excessive compensation.—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings, the excess 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 ordinary tax and surtax.

Art. 23 (a)–6. 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 elements of compensation or excess of reasonable compensation for services, are not deductible from gross income.

Art. 23 (a)–9. Pensions.—Compensation for injuries.—Amounts paid by a taxpayer for pensions to retired employees or to their families or other dependents 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 amounts are limited to an amount not compensated for by insurance or otherwise. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted. As to deductions for payments to employees' pension trusts, see section 23 (p).

Art. 23 (a)–10. Rentals.—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the assumption that he will run his business property at an annual rental rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation.

If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation. (See article 22 (a)–13.)

Art. 23 (a)–11. Expenses of farmers.—A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaging in producing crops which take more than a year from the time of planting to the process of gathering and dispossession may be deducted with the consent of the Commissioner (see article 41–2). To determine what 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, feeding, or labor for a crop regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with article 22 (a)–7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible treated 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 for purposes of business and for the personal use of the taxpayer. In connection with 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 thereof, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also articles 22 (a)–7, 23 (e)–5, and 23 (i)–10.)

Art. 23 (a)–12. Depositors' guaranty fund.—Banking corporations which pursuant to the laws of the States in which they are doing business are required to set aside, 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 aside each year to this fund, provided that such fund, when set aside, is carried to the books 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 the bank; in the event of failure of the bank as a result of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

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

The limitations provided in paragraph (2) of section 23 (a) and in this article apply only to payments which are in fact contributions or gifts to organizations described in section 23 (q). For example, payments by a street railway corporation to a local hospital (which is a charitable organization within the meaning of section 23 (q) and which is carrying on an 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, do not constitute allowable deductions as business expenses. For example, a street railway corporation may donate a sum of money to an organization (of a class not referred to in section 23 (q)) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its cars.

[Sec. 23. Deductions from gross income.]

In computing net income there shall be allowed as deductions:

(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States, as distinguished hereof in the case of a taxpayer who does not signify in his return his desire to have to any extent his interest paid within the year on deposits of banks and loan or trust companies and of the United States is deductible from gross income for the year in which paid or accrued). [See section 121.]

Ann. 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 of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest upon which is wholly exempt from tax, is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (a) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by Title I, or (b) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest upon which is wholly exempt from the taxes imposed by Title I, is deductible in accordance with the general rule.

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

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, article 22 (a)-18 and section 121.)

In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing real estate or other collateral property, by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).

[Sec. 23. Deductions from gross income.]

In computing net income there shall be allowed as deductions:

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

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

(2) Interest, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States; but this deduction is in the case of a taxpayer who does not signify in his return his desire to have to any extent his interest paid within the year on deposits of banks and loan or trust companies and of the United States, provided they are not added to the amount of taxes so paid.

(3) Estate, inheritance, legacy, succession, and gift taxes, and (4) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges of the property benefited; (c) for taxes of foreign countries and possessions of the United States;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

{Sec. 23. Deductions from gross income.]

In computing net income there shall be allowed as deductions:

(d) Taxes of shareholders paid by corporation.—The deduction for taxes allowed by this section (d) 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 case no deduction shall be allowed the shareholder for the amount of such taxes.

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

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

e) Losses by individuals.—In the case of an individual engaged in a trade or business in 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) if property is connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft, and a deduction therefor has not prior to the filing of the return been claimed as a deduction for estate tax purposes in the estate tax return.

Ann. 23 (a)-1. 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 as a deduction for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Act: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses sustained during the taxable year and not compensated for by

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

A loss occasioned by damage to an automobile maintained for pleasure, where such damage results from the faulty driving of the taxpayer or other person operating the automobile, but is not due to the willful act or negligence of the taxpayer, is not deductible. See 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 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 deductible therefrom of section 117, an allowable deduction in an amount not to exceed the excess of the value of the property at the time it was appropriated to income-producing purposes (with proper adjustment for depreciation) over the amount realized from the sale.

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

Cost of property in 1928 $25,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 9 years at 5 percent based on $15,000 value of building converted to business use) 1,800
Selling price of property 16,000

Selling price of property 16,000

Loss computed as provided in section 117 $1,200

Value of property at time it was rented on January 1, 1935 22,000
Less proper adjustment for depreciation 1,800

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 $50,000, of which $10,000 was allocable to the building, but otherwise the facts assumed are the same, the deductible loss, except as limited by section 117, is $2,500, computed as follows:

Cost of property in 1928 $50,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 9 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 117 $4,500

Deductible loss, except as limited by section 117 $2,500

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

Ann. 23 (e)-3. Losses from the sale or other disposition 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 a 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.

Ann. 23 (e)-2. Value of property.—When, in determining the value of a property, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and articles 113 (a) (14)–1, 113 (b)–1, 113 (b)–3, and 113 (b)–3) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as for example, where an increase in the cost or change in the nature of manufactures of any property 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 usual 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 tax return. 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 unless 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 asset and its salvage value, as provided in section 113 (b) and articles 113 (a) (1)–1, 113 (b)–1, 113 (b)–2, and 113 (b)–3 and its salvage value and/or amount realized upon its disposition may be allowed subject to the limitations provided in the Act upon deductions for losses, but only when 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 articles 113 (a) (1)–1, 113 (b)–1, 113 (b)–2, and 113 (b)–3) less its salvage value is allowable upon its retirement. (See articles 23 (d)–1 to 23 (d)–10.)

Art. 23 (e)–4. Shrinkage in value of stocks.—A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and articles 113 (b)–1 to 113 (b)–3 less its value is allowable upon its retirement. (See articles 23 (d)–1 to 23 (d)–10.)

Art. 23 (e)–5. Losses of farmers.—Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. A farmer engaged in raising and selling stock, such as cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used. If 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 live stock, less any depreciation allowable as a deduction in respect of such perishable live stock, may be deducted as a loss if the loss is not compensated for by insurance or otherwise. The actual cost of other property (with proper adjustment for depreciation) which is destroyed and the value of the authority of the 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 sustained, 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 accustomed by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure.

As to losses claimed as deductions for purposes of taxation, see article 23 (g)–1. See also articles 22 (a)–2, 22 (a)–11, and 23 (d)–10.

Art. 23 (d)–1. Losses by corporations.—In the case of a corporation 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 (b), 23 (a)–1, 23 (b)–1, 23 (a)–2, 23 (e)–4, 23 (e)–5, and 23 (d)–1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

Art. 23 (g)–1. Capital losses.—Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (d) for losses sustained on the sale or exchange of capital assets shall be allowed only to the extent provided by this subsection.

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

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

Art. 23 (g)–2. Capital losses.—Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (d) for losses sustained on the sale or exchange of capital assets shall be limited in amount to the extent provided in section 117. Losses sustained by virtue of securities becoming worthless during the taxable year are, under section 23 (g), made subject to the limitations provided in section 117 with respect to sales or exchanges. For purposes of computing the net income of any taxpayer, such losses are to be considered as being sustained from the sale or exchange of the securities on the last day of the taxable year, irrespective of when during such year such securities actually become worthless.

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

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

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

<table>
<thead>
<tr>
<th>Purchase price</th>
<th>$3,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>None</td>
</tr>
<tr>
<td>Actual loss</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

Period stock considered to have been held (February 1, 1937, to December 31, 1938) was 18 months, or 60% of the year.

Percentage of loss taken into account under section 117 (a) was 66% percent, or $3,000 (66% percent of $3,000) (section 117 (a) (6)) was $3,000.

[Sec. 23. Deductions from gross income.]

In computing net income there shall be allowed as deductions:

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

(1) Basis for determining loss. The basis for determining the amount of the 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.

(2) Bad debts.-(a) General rule. Debts are included in gross income. The deduction for bad debts is allowed in the year in which the loss is shown. Any amount subsequently received on an account of such debt shall be included in gross income in the year received. In determining whether a debt is included in gross income for the taxable year in which received, the Commissioner shall consider all pertinent evidence, including the value of the collateral, if any, and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

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

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

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

Taxpayers were given an option for 1931 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) The methods used in the return for 1921 must be used in returns for subsequent years and in returns under the Revenue Act of 1938 unless permission is granted by the Commissioner to change to the other method. A taxpayer's return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also article 166.)

(b) If all the surrounding and attendant circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to the close of the taxable year for which the change is to be effective. (See also article 166.)

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

Art. 23 (k) 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 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 corporation and the amount of the claim which will be allowed with respect to specific debts only.

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

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

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

Art. 23 (k) 3. In computing net income there shall be allowed as a deduction:

(1) Loss on wash sales of stock or securities where the change is to be effective. (See also article 166.)

(2) Loss on wash sales of stock or securities where the change is to be effective. (See also article 166.)
only be included as part of the deduction only if it has previously been returned as income.

As used in section 23 (k) and this article the term "security" means a bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which (A) is a capital asset as defined in section 117, (B) is held by the taxpayer at any time within the taxable year, irrespective of when the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be worthless or partially worthless and charged off. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount, 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 at the date of acquisition.

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

Example 1: On February 1, 1937, A, an individual, who is 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 1936 (his taxable year) the bonds became worthless and he made a proper charge-off during that year. A is entitled to a deduction of $2,000 in computing his net income for 1938. The computation of the amount of the deduction is the same as the computation in the example under article 23 (f).
The need for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as distinguished from loss or damage sustained by the property through casualty, as distinguished from loss or damage sustained by the property through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance. For example, patents and copyrights, licenses, and franchises, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance.

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 amortization of the capital sum over units of production. Whatever plan or method of amortization adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction will be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed. A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. This paragraph may be illustrated by the following example:

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Amount Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1933</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>1934</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>1935</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>1936</td>
<td>$3,000.00</td>
</tr>
<tr>
<td>1937</td>
<td>$5,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>6,000.00</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>1938</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>1939</td>
<td>1,000.00</td>
</tr>
<tr>
<td>1940</td>
<td>2,000.00</td>
</tr>
<tr>
<td>1941</td>
<td>3,000.00</td>
</tr>
<tr>
<td>1942</td>
<td>5,000.00</td>
</tr>
<tr>
<td>1943</td>
<td>6,000.00</td>
</tr>
</tbody>
</table>

Reserve December 31, 1937... 6,000.00
Depreciation for 1938 and subsequent taxable years is $666.67 computed as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th>$10,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve as of December 31, 1937</td>
<td>6,666.67</td>
</tr>
<tr>
<td>Unrecovered cost</td>
<td>3,333.33</td>
</tr>
</tbody>
</table>

Depreciation allowable for 1938 and each taxable year (5% per cent of $10,000) | $666.67 |

**Ann. 23 (1)–6. Obsolescence.**—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may as a whole become obsolescent 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.

**Ann. 23 (1)–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 over the life of the patent or copyright, including any lawful expenditures made within the period 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, including any lawful expenditures made within the period of the patent or copyright, and the amount being computed is 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, all the 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, the property was acquired by gift or transfer in trust after December 31, 1929, 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.

**Ann. 23 (1)–10. Depreciation in the case of farmers.**—A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on live stock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with article 23 (a)–7. Such depreciation should be based on the cost of the property as the estimated life of the live stock. If such live stock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. (See also articles 23 (a)–11 and 23 (e)–3.)

**Ann. 22. Deductions from gross income.**

In computing net income there shall be allowed as deductions:

(i) 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 regular additions in each case; such reasonable allowances 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 that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate 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 equipment for life with remainder to another person, the deduction shall be computed as if the life of the property 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 allowed by operation 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), (e) and (f).

In the case of a farmer, the basis upon which depreciation, exhaustion, wear and tear, and obsolescence are to be charged in respect of any property shall be as provided in section 114.

**Ann. 23 (m)–1. Depreciation 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 (subject to certain exceptions) a reasonable allowance for depletion of minerals, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

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

(1) In the case of coal mines, metal mines, sulphur mines or deposits, and oil and gas wells the aggregate annual allowable deductions may, because of...
percentage depletion, ultimately exceed the cost or other basis;

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

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

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

The principles governing the apportionment of depreciation in the case of property held in trust are also applicable to depletion. (See article 23 (1)-(1).

When used in these articles (23 (m)-1 to 23 (m)-2) covering depletion and depreciation—

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

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

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

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

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

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

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

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

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

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

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

In the case of oil and gas, if the crude mineral product is not sold on the property but is manufactured or converted into a refined product or is transported from the property prior to the sale, then the "gross income from the property" shall be assumed to be equivalent to the market or field price of the oil or gas before manufacture 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." Royalties in the aggregate annual allocations or advanced royalties (see article 23 (m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be equal to that part of such payments which is allocable to the products sold during the taxable year.

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

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

(j) "The property," as used in section 114 (b) (2), (3), and (4) and articles 23 (m)-1 to 23 (m)-19, inclusive, means the interest owned by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." Royalties in the aggregate annual allocations or advanced royalties (see article 23 (m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be equal to that part of such payments which is allocable to the products sold during the taxable year.
“property,” provided such treatment is consistently followed.

Art. 23 (m)-2. Computation of depletion of mines, oil and gas wells, and other natural deposits refers to the recovery of discovery value or percentage depletion.—The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in section 113 (a), adjusted as provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (See articles 113 (a)–1 to 114–1.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year, in the case of sulphur deposits and other natural deposits, the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

As used in this article the phrase, “number of units sold within the taxable year,” in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced and sold prior to the taxable year and the disbursements basis, includes units for which payments were received within 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 (excluding units recovered but not sold) plus the “number of units sold within the taxable year” as defined in this article.

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

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

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

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

The depletion allowance based on discovery value under this article shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property 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 during the taxable year. In the selection of “gross income from the property” and “net income of the taxpayer (computed without allowance for depletion) from the property,” see article 23 (m)-1 (g) and (h). In no case shall the depletion computed under this article be less than it would be if computed upon the cost or basis of the property provided in section 113. In the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 271/2 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 during the taxable year.

For the meaning of “net income of the taxpayer (computed without allowance for depletion) from the property,” see article 23 (m)-1 (g) and (h).

Subject to the qualification specified in the last sentence of this paragraph, a taxpayer making his first return under Title I of the Act (for a taxable year beginning after December 31, 1957) in respect of a property must state as to each such property whether he elects to have the depletion allowance for each such property for the taxable year computed with or without reference to percentage depletion. For the purpose of this paragraph the taxpayer’s first return under Title I of the Act means his return made under that title for his first taxable year (beginning...
after December 31, 1937) for which he has any item of income or deduction with respect to such property. An election once exercised under section 114 (b) and (c) may not be changed by the taxpayer, and the depletion allowance in respect of each such property will for all succeeding taxable years be computed in accordance with the election so made. If the taxpayer fails to make such statements in the return in which such election should, as above indicated, the depletion allowance for the year for which an election must be first exercised and for all succeeding taxable years will be computed without reference to percentage depletion. The method, determined under section 114 (b) (4) and this article, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining the hands of the taxpayer) is, under section 113, determined by reference to the basis of the property in the hands of such taxpayer, whether directly or through one or more substituted bases, as defined in that section. The right of election specified in this paragraph is subject to the qualification that section 114 (b) (4) shall, for the purpose of determining whether the method of computing the depletion allowance follows the property, be considered a continuation of section 114 (b) (4) of the Revenue Act of 1936, and as giving no new election in cases where either of such sections would, if applied, give no new election. (c) The fair market value of a mineral deposit should be determined by the application of factors derived from past operations. 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, cost of development, production, interest rate, and selling price of the product marketed during the expected 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 exploration during the prior periods of production, and selling price of the product marketed. (d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued, and the mineral content of a deposit should be determined by the application of factors derived from past operations. The present value method may be used to establish a reasonable estimate of the value of the mineral deposit. (e) To determine the fair market value of a mineral deposit, the essential factors must be determined for each deposit included in the property. The factors essential in the case of all mineral deposits are: (1) the total operating profit, (2) the rate at which this profit will be obtained, and (3) the rate of interest commensurate with the time of the deposit at the point of extraction. The operating cost of producing, preparing, and marketing the mineral product sold (due con-
For definitions of "development expenses," change of ownership of part of the property prior to the date as of which the value was so determined and applied, or which are derived from different and arbitrarily selected periods.

(e) The number of units of mineral recoverable in marketable form multiplied by the estimated operating profit per unit gives the total expected operating profit. The value of each mineral deposit is, then, the total expected operating profit from that deposit reduced to a present value as of the date as of which the value was so determined and applied 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 to which the valuation is made; relatively higher risks attach to appraisals upon any other basis.

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

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

(a) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23 (m) and article 23 (m)-9, and (b) In cases of the sale of a part of the property between the part sold and the part retained.

Axrr. 23 (m)-9. Determination of mineral contents of mines and of oil or gas wells.—If it is necessary to estimate or determine with respect to any property as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in the ground as of that date, the estimate or determination must be made according to the method currently 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 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 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, (2) as to grade, only as accords with the best indications available as to richness.

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

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

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

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

(d) In lieu of the treatment provided for in the above paragraphs the lessee of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 25 percent of the amount thereof; and the lessees of sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year beginning after December 31, 1937, for which he first makes return in respect of the property (and for subsequent taxable years in case an election is made under section 114(b)) a deduction on a percentage basis has been exercised in the previous return) 25 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 from the property (computed without allowance for depletion) from the property.

Axrr. 23 (m)-11. Depletion and depreciation accounts on books.—Every tax-
property; deduction for depletion or depreciation of mineral property as of a specific date or claiming a deduction for depletion or discovery value; in article 23 (m)-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 any depletions or allowances for capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deduction as may thereafter be allowable under section 114 (b) (2), (3), or (4) and article 23 (m)-4, or 23 (m)-5.

Every taxpayer to whom section 114 (b) (2) and article 23 (m)-3 are applicable shall keep similar accounts with respect to depletion with respect to each mineral property (including oil and gas property):

1. The name, description, location, and identifying number, if any, of the property;
2. Whether taxpayer is a fee owner, lessor, or lessee;
3. The date of acquisition and, if under lease, the exact terms and date of expiration of the lease;
4. The cost of the property, stating the amount paid to each vendor, with his name and address;
5. The date at which the property is valued, if 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 of or value as between deposit of oil or gas 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 oil
11. The amount of depreciation for the taxable year and the amount of depletion for the taxable year computed without reference to percentage depletion or discovery value;
12. The amounts of depletion and depreciation stated separately, which for each and every prior year (A) were allowed, (B) were allowable, and (C) would have been allowable without reference to percentage depletion or discovery value; and
13. Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deduction claimed.

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 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 statement, 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, 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.

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 land or gas land involved, 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 of land, and the percentage of recovery, by units of production, for each year; and the percentage of recovery, stated separately, which for each and every prior year were allowable, and (B) were allowable, and
9. All available geological information, having a probable bearing on the oil or gas content; information with respect to the quality of the formation and the quality of the estimated potential, and characteristics similar to characteristics of other known fields.

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

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

Every person interested in the property shall file a statement provided by the taxpayer, and a property map acceptable to the Commissioner, it cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with article 23 (m)-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 any depletions or allowances for capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deduction as may thereafter be allowable under section 114 (b) (2), (3), or (4) and article 23 (m)-4, or 23 (m)-5.
Article 23 (m)-5, a statement containing the following information with respect to every property for which percentage depletion is allowable:

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

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

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

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

Ann. 23 (m)-14. Discovery of mines other than coal, metal, 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, or sulphur mine) or minerals (other than oil or gas, coal, sulphur, metal, or metallic ores), it must appear that the mine or minerals were not acquired as the result of the purchase of a proven tract or lease; also, the discovery must be made by the taxpayer after February 28, 1913, but such mine 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.

(c) The value of property claimed as the result of a discovery must be the fair market value, as defined in article 23 (m)-4, 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.

Ann. 23 (m)-15. Allowable capital additions in case of mines.—(a) All expenditures in excess of net receipts charged to expense in any given year shall be added to the 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 ore for mining.

(b) Expenditures for plant and equipment and for improvements including expenditures for maintenance and for ordinary and necessary repairs, shall ordinarily be charged to capital account recoverable through depletion. Expenditures for equipment (including its installation and housing) and for replacements which, it is 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.

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

(1) Options 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, supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, laying, 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 these drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs which are allowable as to minerals which constitute the purposes of depletion, can be allowed as to minerals which constitute the purposes of depletion. The taxpayer may find it desirable to furnish such information in all cases.

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

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

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

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

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

(c) Nonoptional items distinguished:

(1) Capital items: The option with respect to tangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily measured as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc.

The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

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

(d) This article does not grant a new option or election. Any taxpayer who made an election or elections under article 23(c) of Regulations 69 or under article 243 of Regulations 74 or under article 247 or under article 23(m)–16 of Regulations 88 or under article 23(m)–16 of Regulations 94 by, such election or elections, bound with respect to all optional expenditures whether made before January 1, 1938, or on or after December 31, 1937, in connection with drilling and casing wells. Any taxpayer who has never made expenditures for drilling or oil or gas wells prior to the first taxable year beginning after December 31, 1937, must make an election, as to intangible drilling and development costs in general, in the return for the first taxable year in which the taxpayer makes such expenditures, and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1937, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (1) in his return for the first taxable year ending after December 31, 1934, in which optional expenditures of the respective types are or were made, or (2) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4026. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1937, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

Ann. 23 (m)–17. Depreciation in the case of mines.—(a) The Act provides that deductions for depreciation of improvements “according to the peculiar conditions in each case” may be taken by a taxpayer owning or leasing mining property. This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence. See articles 23 (i)–1 to 23 (i)–10 as to deductions for depreciation and obsolescence generally. See particularly article 23 (1)–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 reasonable allowance for obsolescence, but minus estimated salvage value shall be recovered (1) at a rate established by current exhaustion of mineral, or (2) by reasonable charges for depreciation (see article 23 (i)–1 at a rate determined by the physical life of the physical life or the economic life of such plant and equipment, or (3) according to the peculiar conditions of the case and 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) in connection with the mining or treatment or other necessary handling of mineral products) may be defined as the estimated time such plant, or unit, when given proper care and repair, can be continued in use despite physical deterioration, decay, wear, and tear.

(d) The estimated economic life of a plant or unit thereof is the estimated time during which the plant or unit may be utilized effectively and economically for its intended purposes and may be limited by the life of the producing portion of the respective type of 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 account of obsolescence cannot 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 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 year, included in the expenses of the respective types of optional items returnable through depletion or depreciation.

Ann. 23 (m)–18. Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowed for depletion as herebefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 23 (m)–16. The amount deductible on this

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account shall be such an amount based upon its cost or other basis equitably distributed over the remaining useful life of the property and such amount shall be recoverable through depreciation. According to its internal useful life or the term of the property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. See articles 23 (1)-1 to 23 (1)-10 as to deductions for depreciation and obsolescence generally. See particularly article 23 (1)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.

Art. 23 (m) - 19. Depreciation and depletion 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 March 1, 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 depletion at January 1, 1916, and proper allocation between depreciation and depletion must be maintained after that date.

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

Art. 23 (m) - 21. Computation of allowance for depletion of timber for given year. - The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber remaining 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) adjusted as provided by section 113 (b) by the number of units of 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 will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts, see articles 23 (m) - 27 and 23 (m) - 28.

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

Art. 23 (m) - 22. Revaluation of timber not allowed. - No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation, fraud or gross error will be made only with the written approval of the Commissioner. The depletion unit should be changed when a revision of the remaining number of units of recoverable timber in the property has been made in accordance with article 23 (m) - 28.

Art. 23 (m) - 23. Depreciation of improvements in the case of timber. - The cost or other basis of development not represented by physical property having a value and thereby recoverable through depletion. 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 depletion 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 operations as determined 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 depletion.

(See articles 23 (1)-1 to 23 (1)-10 as to deductions for depletion and obsolescence generally. See particularly article 23 (1)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

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

(a) Map showing timber and land acquired, timber cut, and timber and land sold;
(b) Description of, cost of, and terms of purchase or lease of, timber and land acquired;
(c) Proof of profit or loss from sale of capital assets;
(d) Description of timber with respect to which claim for loss, if any, is made;
(e) Record of timber cut;
(f) Changes in each timber account as the result of purchase, sale, cutting, reestimate, or loss;
(g) Changes in physical property accounts as the result of additions to or deductions from capital and depreciation;
(h) Operation data with respect to raw and finished material handled and inventoried;
(i) Unit production costs; and
(j) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

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

General forest industries questionnaire

for the years prior to 1919.

Art. 23 (m)–25. Determination of fair
market value of timber.—If the fair
market value of the property at a speci-
died 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 utiliza-
tion, 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 tim-
er 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 ques-
tion with reference to other timber;

(c) Accessibility of the timber (loca-
tion 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, subject to appra-
sal, the probable cost of exploita-
tion, and the climate and the state of
industrial development of the locality);

and

(d) The freight rates by common car-
er to important markets.

The timber in each particular case
will be valued on its own merits and not
on general averages for the region;
however, the value placed upon it,
taking into consideration such fac-
tors 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 sim-
lar properties, the margin between the
cost of production and the price real-
ized for timber products, market value
of similar properties in other regions;
value fixed by the owner for the pur-
pose of the capital stock tax, valuation
for local or State taxation, partnership
accounts, records of litigation in which
the value of the property has been
involved, the amount at which the prop-
erty may have been inventoried or ap-
praised in probate or similar proceed-
ings, disinterested appraisals by ap-
proved methods, and other factors.
For depletion purposes the fair market
value at a specified date shall not include any
part of the value of the land.

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

Art. 23 (m)–26. Determination of quantity
of timber.—Each taxpayer
claiming or expecting to claim a deduc-
tion for depletion is required to esti-
mate with respect to each separate tim-
ber 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 speci-
died 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 tim-
er had been harvested in accord-
ance 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, or
changes in standards of utilization, or
losses not otherwise accounted for, of
abandonment of timber, or of operations
or development work, it is ascertained
by the taxpayer or the Commis-
ioner that there remain on the ground,
available for utilization, more or less
units of timber than remain in the tim-
ber account or accounts on the basis
of the original estimate, then the original
estimate (but not the basis for deple-
tion) shall be revised and the annual
deposition allowance with respect to the
property for subsequent taxable years
shall be based upon the revised estimate.

Art. 23 (m)–27. Aggregating timber
and land for purposes of valuation
and accounting.—With a view to logical
and reasonable valuation of timber, the tax-

payor shall include his timber in one or
more accounts. In general, each such
account shall include all of the tax-
payer's timber which is located in one
"block," a block being an operation unit
which includes all of the taxpayer's tim-
er which would logically be removed
to a single given point of manufacture.
In those cases in which the point of manuf-

Act. 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, im-
provements, and equipment used in con-
nection therewith) shall keep accurate
ledger accounts in which shall be rec-
corded the cost or other basis provided
by section 113 (a), as the case may be,
of the property, and the plants, improve-
ments, and equipment, together with
all allowable capital additions to
each account and all of the other ad-
justments provided by section 113 (b)
and articles 113 (a) (14)–1, 113 (b)–1,
113 (b)–2, and 113 (b)–3. In such accounts
there shall be set up separately the quantity of timber, the
quantity of land, and the quantity of
other resources, if any, and a propri-
ate part of the total cost or value shall be
allocated to each. (See article 23 (m)–27.)

These accounts shall be credited with
the amount of the depletion or depre-
ciation deductions computed in accord-
ance with article 23 (m)–26.
In computing net income there shall be allowed as deductions:

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

1. the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes;
2. a domestic corporation, or domestic community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise opposing to influences opposed to secular legislation;
3. the special fund for vocational rehabilitation authorized by section 12 of the World War Veterans' Act, 1924;
4. posts or organizations of war veterans, or auxiliary units or societies of any such posts or organizations, if such posts, organizations, units, or societies are organized in the United States, or by any of its possessions, and no part of their net earnings inures to the benefit of any private shareholder or individual;
5. a domestic fraternal society, order, or association, operating under the lodge system, but only if such contributions or gifts are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;

Art. 23 (o).—Contributions or gifts by individuals.—A deduction is allowable under section 23 (o) only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A deduction is not allowable, however, for the actual payment of a contribution or gift if the amount of such payment already has been deducted on the accrual basis in computing net income for any taxable year beginning before January 1, 1938. A contribution or gift to a domestic organization described in section 23 (o) is deductible even though some portion of the funds of such organization is or may be used in foreign countries for charitable and educational purposes. This article does not apply to contributions or gifts by estates and trusts (see section 162). No deduction is allowed in computing the net income of a common trust fund or a partnership for contributions or gifts made to organizations described in section 23 (o). (See sections 169 and 183.) However, a partner's proportionate share of contributions or gifts actually paid by a partnership during its taxable year to such organizations may be allowed as a deduction in his individual personal return for his taxable year with or within which the taxable year of the partnership ends, to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 percent of his net income computed without the benefit of the deduction for contributions. In the case of a nonprofit alien organization, or a citizen of the United States entitled to the benefits of the special fund for vocational rehabilitation, the full amount of contributions made to the organization is deductible only for the contribution paid during the taxable year to which the deduction is allowable and the deduction is 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 was exempt from tax under section 165, or any year or years of the trust commencing after the year in which the employer ceases to be subject to this 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 not 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, relating to trusts created for the exclusive benefit of employees shall be allowed to deduct from gross income reasonable amounts paid to such trust, out of the income earned from the pension plan (including any reasonable amendment thereof), as follows:

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

[Sec. 23. Deductions from gross income.]
(b) If the plan does not contemplate the payment to the trust, in advance of the time when pensions are granted, of amounts to provide for future pension payments, then:

(1) Reasonable amounts paid to the trust shall be allowable only with respect to a tax year representing the present value of the expected future payments in respect of pensions granted to employees retired during the taxable year. The amount of any reasonable amount transferred or paid to the trust during the taxable year shall be allowable as a deduction for such year as an ordinary and necessary business expense. The amount transferred or paid during the taxable year representing the present value of the expected future payments in respect of pensions granted to employees retired during the taxable year shall be allowable only with respect to the tax year in which the payment to the trust, in advance of the time when the pensions are granted, is made.

(2) One-tenth of a reasonable amount transferred or paid to the trust during the taxable year to cover in whole or in part the present value of the expected future payments in respect of pensions granted to employees retired prior to the taxable year, or so transferred or paid to place the trust on a sound financial basis, shall be allowed as a deduction for the taxable year and for each of the nine succeeding taxable years.

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

If any portion of the funds of an exempt pension trust reverts to the possession, ownership, or control of the employer by reason of the termination of the trust or otherwise, such amount (except to the extent that it represents a payment to the pension trust made by the employer in accordance with the plan of the trust and established a pension trust which was exempt from tax under section 165. During the year and upon the basis of an actuarial computation the company paid $2,500,000 to the trust. At the time the fund was transferred to the trust in accordance with the pension plan of the company, the pension liability applicable to the years prior to 1939, in respect of employees then on the retired roll, for pensions to be paid in the future, was $2,500,000. In addition, in respect of employees on the active roll, for pensions to be paid in the future, was $6,500,000; the payment required to cover the pension liability applicable to the years prior to 1939, in respect of employees on the active roll, for pensions to be paid in the future, was $360,000.

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

Example (2)—Accruals on basis of pensions granted: In 1939 the N Company adopted a reasonable pension plan and established a pension trust exempt from tax under section 165 of the Revenue Act of 1938 but which would not be exempt from tax for taxable years beginning after December 31, 1938, under section 165 of the Revenue Act of 1938. The N Company made all necessary changes in the pension trust plan, shall likewise be filed.

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

Example (2)—Accruals on basis of pensions granted: In 1939 the N Company adopted a reasonable pension plan and established a pension trust exempt from tax under section 165 of the Revenue Act of 1938 but which would not be exempt from tax for taxable years beginning after December 31, 1938, under section 165 of the Revenue Act of 1938. The N Company makes all necessary changes in the trust so as to satisfy the requirements of section 165 of the Revenue Act of 1938. The N Company is entitled to an annual deduction of $5,000 for the remaining portion of the 10-year period which began in 1937. If, however, the N Company does not make the necessary changes so as to satisfy the requirements of section 165 of the Revenue Act of 1938 with respect to taxable years beginning after December 31, 1938, it is not entitled to any further deductions under section 23 (p). If it did not make such necessary changes until December 31, 1939, it is entitled to a deduction of $8,500 for the year 1939 but is entitled to such annual deduction, however, for all subsequent taxable years up to and including the calendar year 1946.
ments constituting a part of the plan must be filed with the return for the first taxable year for which allowance of deductions under section 23 (p) may be affected by such changes in the pension trust plan.

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

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

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

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

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

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

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

5. A schedule showing the receipts and disbursements of the pension fund during each taxable year carried forward from the date of the last actuarial valuation to the date of the actual payment of the contributions or gift, (2) the substantiation of the claims for deductions when required by the Commissioner, and (3) the basis for calculation of the amount of a contribution or gift which is other than money, are equally applicable to claims for deductions of contributions or gifts by corporations under section 23 (q).

Sec. 24. Items not deductible.—(a) Gross receipts.—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses (a) Any expenditures or for permanent improvements or betterments made to increase the value of any property or estate;

(2) Any amount expended in restoring property or in making payments to third persons for which no allowance is or has been made;

(3) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in the corporation for whose benefit the policy is issued, by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy;

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

(b) Losses from sales or exchanges of property.—(1) 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 he is, directly or indirectly, or for the same individual, or if either of such corporations, with respect to either of them, is a personal holding company or a foreign personal holding company;

(C) Between a grantor and a beneficiary of a trust;

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

(E) Between a beneficiary of a trust and a beneficiary of such trust.

(2) Stock ownership, family, and partnership rule.—For 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 belonging proportionately to or for its shareholders, partners, or beneficiaries;

(B) An individual shall be considered as owning the stock owned, directly or indirectly, by or through his spouse or children,

(C) An individual owning (other 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), cousins, ancestors, lineal descendants, and lineal descendants of the individual;

(E) Constructive ownership as actual ownership.—Stock constructively owned by a person by reason of any of subparagraphs (A), (B), or (C) shall, for the purpose of applying subparagraph (A), (B), or (C), be treated as if actually owned by such person, but stock constructively owned by an individual by reason of the application of subparagraph (B) or (C) shall 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.

(1) Unpaid expenses and interest.—In computing net income no deduction shall be allowed in any case for (a) underwriting 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 to the taxpayer of such the taxable year of whom losses would be disallowed under section 24 (b).
(3) If, at the close of the taxable year of whom losses would be disallowed thereafter, both the taxpayer and the person to whom the payee in the value of such interest due to the lapse of time, not by any deduction allowed by this Act (except the deductions provided for in subsection (b), (c), and (d) of section 24) for the purpose of computing the net income of the corporation, the corporation, the corporation, such as incorporation fees, capitalized expenditures and not deductible under any provision of section 22 or section 116 of the Act; and any item or class of income, other than interest, exempt under the provisions of any other law from the taxes imposed by Title I.
The object of section 24 (a) (6) 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 along with all items of income excluded from the computation of gross income under section 22, so this provision of the Act excludes from the computation of deductions under section 23 all items referable to the production of exempt income, other than exempt interest.
(b) Determination of amounts allocable to a class of exempt income.—No deduction may be allowed for the amount of any item or part thereof allocable to a class of classes of exempt income. Items, or parts of such items, directly attributable to any class or classes of exempt income, shall be allocated thereto; and items, or parts of such items, directly attributable to any class or classes of taxable income, shall be allocated thereto.
If an item is indirectly attributable to taxable income and exempt income, reasonably determined, in the light of all the facts and circumstances in each case, shall be allocated to each. Apportionments must in all cases be reasonable.
For example, if the compensation of an officer or employee of a State is income from the Federal taxing power, such compensation is disregarded in computing the gross income of the officer or employee, and no deductions from gross income may be made for his expenses in performing the service for which the compensation is paid, or for the State income taxes imposed on the compensation, or for losses or depreciation attributable to the property used in performing such service, or for any portion of overhead expenses so attributable.
(c) Statement of items of exempt income.—Every taxpayer maintaining a record of items 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, show-
ing (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 hereabove referred to not in any way referable to exempt income). The taxpayer shall keep such records as will enable him to make the allocations required by this article (see section 54).

Arr. 24-5. Losses from sales or exchanges between certain classes of persons.—(a) Individuals (including fiduciaries).—In the case of sales or exchanges of property, directly or indirectly, between individuals (including fiduciaries) section 24 (b) (1) provides that no deduction shall be allowed with respect to losses arising therefrom in the following cases:

(1) between members of a family as defined in section 24 (b) (2) (D); (2) between fiduciaries of trusts having a common grantor; (3) between a grantor and a fiduciary of the same trust; or (4) between a fiduciary of a trust and a beneficiary of such trust.

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

(c) Stock ownership rules.—For the purpose of paragraph (b) of this article, the ownership of stock shall be determined in accordance with the rules provided in section 24 (b) (2). In order that an individual shall be considered under section 24 (b) (2) (A) as constructively owning the stock of a corporation, either directly or indirectly, by or for him, such individual must himself own, directly or indirectly, stock of such corporation. On the other hand, under section 24 (b) (2) (B) an individual may own constructive stock of a corporation, either directly or indirectly, in order to be considered as constructively owning the stock of such corporation which is owned, directly or indirectly, by or for any member of his family.

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

Example (1): On July 1, 1938, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1937 was a personal holding company under section 78 of Title I-A of the Revenue Act of 1936, as amended by the Revenue Act of 1937. On that day all of the outstanding stock of the M Corporation was owned by A. By the application of the rule provided in section 24 (b) (2) (A), the stock in the O Corporation owned by the M Corporation is considered to be owned constructively by A, the sole stockholder of the M Corporation. Such constructive ownership of the stock of the O Corporation by A is considered as actual ownership for the purpose of applying the family rule provided in section 24 (b) (2) (B) to make a member of A's family, as, for example, his wife AW, the constructive owner of the stock of the O Corporation. But the constructive ownership of the O Corporation stock by A is not 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, ATF, 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, ATF, 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 or after June 15, 1938, between any of such individuals or corporations, except as between A and AW and between ATF and the M or O Corporation.

Example (2): On June 15, 1938, all of the stock of the N Corporation was owned by A and his wife, AW, partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1938, between A and the N Corporation or AP and the N Corporation. Immediately after the application of section 24 (b) (2) (C), each partner is considered as having owned the stock of 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 permitted by section 24 (b).

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

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

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

No deductions shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, if the date of purchase of the estate or trust is entitled to a deduction under the Act but there is no reduction of the income of the life or terminable interest. For example, an

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Credits Against Income

Sec. 25. Credits of individual against net income.--(a) Credits for normal tax only.--There shall be allowed for the purpose of the normal tax, but not for the surtax, the following credits against the net income of an individual for the United States: obligations of the United States.—The amount received as interest on obligations of the United States which is included in gross income under section 22.

(b) Interest on obligations of instrumentalities of the United States.—The amount received as interest on obligations of any 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 issuance thereof, as amended and as implemented, such interest is exempt from normal tax.

(c) 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.

(d) Earned income definition.—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 reason which is based on a percentage of the gross income from business or other services.

(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 gross income.

(C) "Earned net income" means the excess of the amount of the earned income over the sum of the earned income deductions. In the case of a taxpayer's net income is less than $3,000, his entire net income shall be considered earned net income. If his net income is more than $3,000, his earned net income shall not be considered to be more than $14,000.

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

1. Personal exemption.—In the case of a single person or a married person not living with husband or wife, a personal exemption of $1,000; or in the case of a married person living with husband or wife, a personal exemption of $2,500. A husband and wife living together in the States shall be entitled to a deduction of $500 for each $1,000 or fraction thereof of their joint earned net income.

2. Credit for dependents.—$400 for each person (other than husband or wife) dependent upon and residing with the taxpayer for the year, provided that the taxpayer is not himself a dependent as hereinafter defined.

3. Change of status.—If the status of the taxpayer, as a result of either the personal exemption or credit for dependents, changes during the taxable year, the personal exemption or credit shall be apportioned and adjusted, under 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 deemed to be an amount equal to one-twelfth of a month.

The entire amount received as professional fees, and other amounts received as compensation for personal services actually rendered by the taxpayer in the course of his business and $10,000, but not in excess of $8,000. He is entitled to an earned income credit of $300, computed as follows:

- Gross income: $40,000
- Less earned net income: $20,000
- Earned income credit: $300

Example: An individual received a salary of $30,000 as a traveling salesman for the calendar year 1938. His allowable deductions under section 23 for that year amounted to $12,000, of which $5,000 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:

- Gross income: $20,000
- Less earned net income: $8,000
- Earned income credit: $800

Example: During the calendar year 1938 an individual was engaged in a business in which both personal services and capital were income-producing factors. A reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income, but the total amount which shall be treated as the earned income of the taxpayer from such a trade or business shall, in no case, exceed 20 percent of his share of the net profits of such trade or business. No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors, but this question must be determined with respect to the facts of the individual cases.

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

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

- Gross income: $6,000
- Less earned net income: $4,000
- Earned income credit: $300

Example (2): An individual received a salary of $30,000 as a traveling salesman for the calendar year 1938. His allowable deductions under section 23 for that year amounted to $12,000, of which $5,000 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:

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- Less earned net income: $8,000
- Earned income credit: $800

Example 3: During the calendar year 1938 an individual was engaged in a business in which both personal services and capital were income-producing factors. A reasonable allowance as compensation for the personal services actually rendered by the taxpayer 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.

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

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

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

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

Art. 25-6. Credit for dependents.—A taxpayer, other than a nonresident alien who is not a resident of Canada or Mexico (see section 214), receives a credit of $400 for each person (other than husband or wife), whether related, unrelated, or a person living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under 18, or (b) incapable of self-support because defective. The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.

Art. 25-7. Personal exemption and credit for dependents where status changes.—If the status of the taxpayer changes during the taxable year, the personal exemption allowed by section 25 (b) (1) to a single person, a married person not living with husband or wife, a head of a family, or a married person living with husband or wife, and the credit for dependents allowed by section 25 (b) (2) will be apportioned according to the number of months during which the taxpayer occupied each status. A taxpayer not having the status of a head of a family or the status of a married person living with husband or wife during the preceding months of the taxable year to the date of the decedent’s death, may claim a personal exemption of $1,291.67; that is, 1/3 of $2,500, for the period from the beginning of the taxable year to the date of the decedent’s death, plus 1/3 of $1,000, or $333, for the period from the date of the decedent’s death to the close of the taxable year. If A, the surviving spouse, makes a return for 1938 on the calendar year basis, he may claim a personal exemption of $1,291.67; that is, 1/3 of $2,500, or $1,145.33, plus 1/3 of $1,000, or $333. However, the combined personal exemption of A and B for the period during which they were married and living together, that is, 1/3 of $2,500, or $2,291.67, may by agreement be taken either by A or B or divided between them in any proportion.

Example (2): A and B, who were heads of families during the first six months of 1938, were married on July 1, 1938, and lived together during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1938, the joint exemption will be $2,500; that is, 1/2 of $2,500 for A while the head of a family, plus 1/2 of $2,500 for B while the head of a family, plus 1/2 of $2,500 for the period during which they were married and living together. If separate returns are made by A and B, each may claim a personal exemption of $1,291.67; that is, 1/3 of $2,500, plus 1/3 of $2,500 for the period during which they were married and living together. In the latter case, however, the joint exemption of 1/3 of $2,500 may by agreement be taken either by A or B or divided between them in any proportion.

Example (3): A and B were married and living together until November 30, 1938, when B, the wife, died. They had no dependents. The executor or administrator in making a return for B may claim a personal exemption of $1,291.67; that is, 1/3 of $2,500, or $1,145.33, plus 1/3 of $1,000, or $333, for the period from the beginning of the taxable year to the date of the decedent’s death, plus 1/3 of $1,000, or $333, for the period from the date of the decedent’s death to the close of the taxable year. If A, the surviving spouse, makes a return for 1938 on the calendar year basis, she is entitled, in addition to the personal exemption allowed under section 25 (b) (1), to a credit for dependents in the amount of $200; that is, 1/3 of $2,500.

Example (4): A furnished the chief support of a child under 18 years of age until the death of the child on June 30, 1938. If A makes a return on the calendar year basis for 1938, he is entitled, in addition to the personal exemption allowed under section 25 (b) (1), to a credit for dependents in the amount of $200; that is, 1/3 of $600.

Example (5): A and B were married and living together until June 30, 1938, when A, the husband, died. Prior to the date of death, A was the chief support of a child 10 years of age. B, the surviving spouse, was the chief support of the child during the remainder of the year. If B makes a return for 1938 on the calendar year basis, she is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $200; that is, 1/3 of $600.

Sec. 55. Credits of corporations.—In the case of a corporation the following credits.
shall be allowed to the extent provided in the various sections imposing tax-

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

(b) Dividends received. — 85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation, and 65 per centum of the amount received as dividends from a foreign corporation not wholly tax-exempt, shall be allowed as a credit under section 26 (a) (2) of the calendar year. However, the credit allowed shall be reduced in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation organized under the Act of the U.S. but not wholly tax-exempt, by 10 per centum. The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is included in gross income under such obligations, as amended and supplemented by the Act authorizing the issue of obligations of a corporation organized under Act of Congress (if such corporation is an insurance company), which is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

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

(2) Amount allowed. — In this subsection the term "net operating loss" means the excess of the deductions allowed by this title over the following excepting and limitations:

(A) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or percentage depletion under section 114 (b) (2), (3), or (4) (see article 23 (m) to 3). The basis for such depletion is the basis provided in section 118 (a), adjusted as provided in section 118 (b), for the purpose of determining the sale proceeds of the property involved.

In computing the gross income for the preceding taxable year there shall be included the excess, if any, of the amount of any interest received which is wholly exempt from the taxes imposed by this title, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 26 (a) (2), (3), or (4), or (5), or (6) (see article 23 (m) to 3), over the amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is included in gross income from sources within the United States or of corporations organized under Act of Congress which is included in gross income from sources within the United States and its instrumentalities.

(d) Bank affiliates. — In the case of a holding company affiliate (as defined in section 2 of the Bank Holding Company 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.

(e) Dividends paid credit. — For corporations dividends paid credit, see section 25.

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

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

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

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

In computing deductions for the preceding taxable year any deduction for depletion shall be computed without reference to discovery value or percentage depletion under section 114 (b) (1), (2), (3), or (4) (see article 23 (m) to 3). 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 sale proceeds of the property involved.

The aggregate of the credits allowable under the various sections imposing tax on the income or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock; (3) upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No credit is allowable under section 26 (d) for the amount of readily marketable assets acquired and on hand at the beginning of the first taxable year subject to the Revenue Acts of 1938, whether or not a credit was allowed for all or part of such amount under section 26 (d) of the Revenue Act of 1938, or for an amount of readily marketable assets in excess of what is required by such section 5144 to be acquired by such affiliate, or in excess of the net income of such holding company affiliate for the taxable year. Nor may the aggregate of the credits allowed under section 26 (d) of the Revenue Acts of 1938 and 1939 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 for in any year, 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

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the Board of Governors at the time of the filing of the return. The holding company also furnished to 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 the corporation in which a voting permit has been granted, see subsections (b) and (c) of section 5144 of the Revised Statutes (paragraph 64 of the Appendix to these regulations).

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

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

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

(3) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1938), exceeds the amount of the deficit in the accumulated earnings and profits of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. Where the indebtedness is for a principal sum, with interest, no credit shall be allowed under this paragraph for amounts used or set aside to pay such interest.

Art. 27 (a)–1. Dividends paid credit.—The amount of the dividends paid credit provided by section 27 (a) is in substantial equivalence to the following:

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

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

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

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

Art. 27 (a)–3. Amounts used or irrevocably set aside to pay or to retire indebtedness.—(a) Definition of the term "indebtedness."——The term "indebtedness" means a debt or obligation of the corporation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount, existing at the close of business on December 31, 1937, and evidenced at the time payment is made of amounts which are irrevocably set aside by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, 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. 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 December 31, 1937, will not be deemed as indebtedness for the purposes of section 27 (a) (4).

(b) Amounts used or irrevocably set aside.—The credit is allowable in any to the total principal amount of the instrument or instruments surrendered (as, for example, where $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 resale of a lost or destroyed instrument, or the issue of a new instrument to a transferee, will not deprive a corporation of the benefits of section 27 (a) (4).

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

The credit provided by section 27 (a) (4) extends only to amounts used or irrevocably set aside to pay or to retire the principal of indebtedness evidenced by the types of obligations enumerated in that section. The denial of a credit for amounts used or set aside to discharge an obligation to pay interest applies whether the interest involved became due on, before, or after January 1, 1938. If interest is allowable as a deduction under section 23 (b) or a corresponding section of a prior income tax law when paid or accrued or would be so allowable if it were not for the exception contained in 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 of or all of the principal amount of an obligation of the character described in section 27 (a) (4).

Indebtedness incurred through the assumption of the liabilities of another is not indebtedness within the meaning of section 27 (a) (4), even though such assumption took place prior to January 1, 1938, unless evidenced by one or more of the instruments enumerated in such section, issued by the taxpayer prior to, and in existence at, the close of business on December 31, 1937. Similarly, indebtedness represented by a renewal of the term of an instrument after December 31, 1937, will not be deemed as indebtedness for purposes of section 27 (a) (4).
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 sinking fund obligation will, in no event, 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. The fact that the 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. However, 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 trusts required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the statutory requirement of reasonableness. To be considered reasonable it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted prior to 1938, no adjustment is allowable in respect of the amounts set aside in the years prior to 1938.

[Sec. 27, Corporation dividends paid credit.]

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

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

(2) In the case of a taxable year beginning after December 31, 1938, the net operating loss credit provided in section 26 (c) (1) (if the current taxable year began after December 31, 1938) and the bank affiliate credit provided in section 26 (d).

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

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

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

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

(2) The smaller of the following:

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

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

Art. 27 (b)-2. Dividends paid.—(a) When dividends are considered paid.—A dividend will be considered as paid when it is received by the shareholder. An allowance for dividends paid will not be permitted unless the shareholder receives the dividend during the taxable year for which the credit is claimed. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover marked "Due within 10 days," the check will be considered as paid when it is received by the shareholder. An allowance for dividends paid will not be permitted unless it be shown to the satisfaction of the shareholder to the corporation in keeping its books or upon the return provided by the corporation during its taxable year in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the net income of the corporation is computed. See section 43.

(c) Records.—Every corporation claiming an allowance for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such allowance is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (a) a copy of the dividend resolution; and (b) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (1) the medium of payment and (2), if 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 receipt 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 dividend carry-over.—There shall be computed with respect to each taxable year of a corporation a dividend carry-over to
Every corporation claiming a dividend carry-over for any taxable year shall file its return for such year with its report setting forth the amount of the dividend carry-over claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carry-over claimed.

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

**Example (1):** The X Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $150,000 and dividends paid credit (computed without regard to any dividend carry-over) of $150,000 for 1937. For 1938 its adjusted net income is $50,000 and its basic surtax credit is $75,000, and for 1939 its adjusted net income and basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1940 is $100,000, computed as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjusted net income</th>
<th>Basic surtax credit</th>
<th>Excess of basic surtax credit over adjusted net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937</td>
<td>$150,000</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>1938</td>
<td>$50,000</td>
<td>$75,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>1939</td>
<td>$25,000</td>
<td>$75,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

| Dividend carry-over to 1940 (sum of (3) and (6)) | $50,000 |

For reasons why the year 1937 is not taken into account, see explanation at end of example (1).

**Example (2):** The Y Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $100,000 and its adjusted net income and basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1940 is $100,000, computed as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjusted net income</th>
<th>Basic surtax credit</th>
<th>Excess of basic surtax credit over adjusted net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937</td>
<td>$100,000</td>
<td>$25,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>1938</td>
<td>$25,000</td>
<td>$25,000</td>
<td>$0,000</td>
</tr>
<tr>
<td>1939</td>
<td>$25,000</td>
<td>$25,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

| Dividend carry-over to 1940 (sum of (3) and (6)) | $50,000 |

For reasons why the year 1937 is not taken into account, see explanation at end of example (1).
respectively, the dividend carry-over to 1938 would be $5,000, computed as follows:

**Year 1938**

1. Basic surtax credit (i.e., dividends paid credit) $160,000
2. Less adjusted net income $90,000
3. Excess of basic surtax credit over adjusted net income $70,000

**Year 1937**

4. Adjusted net income $120,000
5. Less basic surtax credit (i.e., dividends paid credit) $25,000
6. Excess of adjusted net income over basic surtax credit $95,000
7. Dividend carry-over to 1938 (3) minus (6) $5,000

The year 1935 cannot be taken into account because it began prior to January 1, 1938.

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

(d) Dividends in kind.—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the amount with respect thereto which shall be used in computing the basic surtax credit shall be the adjusted basis of the property in the hands of the corporation at the time of payment, or the fair market value of the property at the time of the payment, whichever is the lower.

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

1. The adjusted basis of such property in the hands of the corporation as provided for in section 113; or
2. The fair market value of such property.

As used in this article the term "property" includes shares of capital stock of the corporation making the dividend distribution if such shares of stock are held by it as an investment. Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment. The term "property" also includes obligations upon which the corporation making the distribution is liable as a guarantor, indemnor, or surety. The allowance for dividends paid and as of the date of payment is limited to the fair market value of the corporate obligations distributed and the corporation redeems such obligations in a taxable year beginning after December 31, 1931, the 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 an additional allowance regardless of the identity of the holders of the obligations at the time of their redemption.

The term "obligations" as used in this article means any legal liability on the part of the corporation (not including liability as a guarantor, indemnor, or surety), regardless of when incurred, to pay a fixed or determinable sum of money, evidenced in writing executed by the corporation. The term "redeemed" as used in this article includes (1) repurchase in the open market for investment or sinking fund purposes, (2) retirement, or (3) cancellation of the obligations before, at, or after maturity.

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

**Example:** The X Corporation, which makes a taxable income tax return on a calendar year basis, declared a dividend of $50,000 in 1936, payable in that year in its 5 percent bonds at 85. Pursuant to such declaration, bonds having an aggregate face value of $100,000 were issued during 1936 in payment of the dividend. The fair market value of the bonds at the time of issuance was $75,000. The dividends paid credit for 1936 was the fair market value of the bonds at the time of the dividend payment ($75,000), since such fair market value was lower than the face value ($100,000) of the obligations.

The bonds were redeemed in 1938. The corporation prior to the redemption of the bonds at face value deducted in its returns over the life of the bonds the $15,000 bond discount resulting from the payment in 1936 of the $85,000 dividend in bonds having a face value of $100,000. The allowance for dividends paid for purposes of computing the basic surtax credit with respect to the bond redemption for the taxable year 1938.
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 paid in 1938. $75,000
Difference. $25,000.

Less bond discount allowed as a deduction in computing net income. $15,000

Amount treated as dividend paid in 1938. $10,000

[Sec. 27. Corporation dividend paid credit.]

(g) Distribution in liquidation.—In the case of amounts distributed in liquidation, the part of such distribution which is properly chargeable to earnings or profits accumulated after February 28, 1913, is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, [of the stock] with respect to such transactions.

Amount properly chargeable to earnings or profits.—In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this article) the amount of such 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 paid-in surplus but, such corporate items, if any, which, for purposes of income taxation, are treated as 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 any surplus on redemption 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 holder at any time at $105 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 $100 per share, for a total of $100,000, and the common stock, at $100 per share, for a total of $200,000. On July 15, 1938, the company had a paid-in surplus of $5,000, consisting of the premium received on the preferred stock, earnings or profits of $50,000 accumulated prior to March 1, 1912, and earnings or profits accumulated since February 28, 1913, of $75,000. On July 15, 1938, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $115 per share, for a total of $115,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Act, such transaction being only a partial liquidation under section 115 (e). The amount of the distribution allocable to earnings or profits accumulated since February 28, 1913, was $1,100,000 ($110,000 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, $205,000 ($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 which 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 transferee as a distribution out of such earnings or profits of the transferee. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated. For the purposes of the allowance for dividends paid, any such distribution so allocated shall be treated as a dividend paid only in the computation of the basic surtax credit allowable to the transferee, and must be consistently 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

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conclusively 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 transferee corporation; and (2) a certified copy of the resolution of all 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 transferee 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 examples:

Example (1): The P Corporation, which makes its income tax returns on the calendar year basis, has a capital in the amount of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1938, the P Corporation distributed $50,000 in cancellation of 50 shares of the par stock owned by three of the four shareholders of the corporation. No dividends paid credit is allowable under section 27 (h) with respect to such distribution.

Example (2): The N Corporation, which makes its income tax returns on the calendar year basis, has a capital in the amount of $100,000, $80,000, $60,000, $40,000, and $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 $50,000, in addition to earnings or profits of the taxable year computed as of the end of the year in the amount of $80,000, and an adjusted net income in the amount of $60,000. The P Corporation pays dividends as follows: June 15, 1938, $25,000; September 15, 1938, $25,000; December 15, 1938, $25,000; and March 15, 1939, $25,000. No portion of the dividend paid on March 15, 1939, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).

[Sec. 27. Corporation dividends paid credit.]
(h) Preferential dividends.—The amount of any distribution (although each portion thereof is received by a shareholder as a taxable dividend), not made in connection with a consent distribution (as defined in section 28 (a) (4)), shall not be considered as dividends paid for the purpose of computing the basic surtax credit, unless such distribution is pro rata and in such manner as to increase the capital interest of any shareholder in the corporation. The Commissioner shall be satisfied that no disallowance is made, every shareholder of the class of stock with respect to which the distribution is made 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 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 December 15, 1938, declared a dividend of $5 per share payable in cash on August 1, 1938, to A. On September 15, 1938, it declared a dividend of $5 per share payable in cash on October 1, 1938, to B, C, and D. No allowance for dividends paid for the taxable year 1938 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1938, and October 1, 1938.

Example (2): The N Corporation, which makes its income tax returns on the calendar year basis, has a capital in the amount of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1938, the N Corporation distributed $50,000 in cancellation of 50 shares of the par stock owned by three of the four shareholders of the corporation. No dividends paid credit is allowable under section 27 (h) with respect to such distribution.

[Sec. 27. Corporation dividends paid credit.]
(i) Nontaxable distributions.—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such shareholders as are subject to taxation under this title for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit.

Art. 27 (h)–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 on the date of the distribution (see section 115), and a distribution in liquidation referred to in section 27 (g).

The application of the provisions of section 27 (h), relating to distributions which are preferential, may be illustrated by the following examples:
accompany 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

or the last day of such period and is entitled to receive the payment of capital stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and articles 115-3 and 115-4).

The effect of subsections (b) and (i) of section 27 is that no allowance for dividends paid may be included in the basic surtax credit with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under Title I for the period in which the distribution is returned on the taxable dividend as a result of the distribution. (See also section 27 (g.))

The application of section 27 (i) may be illustrated by the following examples:

Example (1): A, B, C, and D are the shareholders of the Y Corporation, which makes its income tax returns on the calendar year basis, D being an educational corporation exempt from income tax under section 27 (a). On July 15, 1938, the Y Corporation paid a dividend within the meaning of section 115 in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

Example (2): If the facts in the preceding example are the same, except that A and B make their returns on the calendar year basis, and 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.

Sec. 28. Consent dividends credits.

(a) Definitions.-As used in this section--

(3) 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 (or in liquidation) of earnings or profits, or both. It is not a preferred dividend, however, unless it is preferred over a subsequent distribution (or in liquidation) of earnings or profits, with respect to some other class or classes of stock than the one on which it is payable.

Art. 28 (a) (2): 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 earnings or profits 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 (or in liquidation) of earnings or profits, with respect to 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 is 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 $3 per share and $6 per share of the amount distributable on class B are paid, and class B is entitled to receive in conjunction with the payment to class A of its last $3 per share a preferred dividend, because the payment of such amount is preferred over any subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $5 on class B, then on class A and class B share and share alike, the distribution on class A of $5 and on the distribution on class B of $5 are both preferred dividends.

[Sec. 28. Consent dividends credits.

(a) Definitions.-As used in this section--

(3) 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, or both. It is not a preferred dividend, however, unless it is preferred over a subsequent distribution (or in liquidation) of earnings or profits, with respect to some other class or classes of stock than the one on which it is payable.

Art. 28 (a) (3)-1. Consent dividends day.-The term "consent dividends day" is defined in section 28 (a) (3). If there was no partial distribution (as defined in section 28 (a) (3)) payable during the last month of the corporation's taxable year, the consent dividends day is the last day of such month. 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 authorizing the distribution, are entitled to receive the distribution is the day it is payable.

[Sec. 23. Consent dividends credits.

(a) Definitions.-As used in this section--

(4) Consent distribution.-The term "consent distribution" means the distribution which on any class of stock is a condition precedent to a further distribution, evidenced by shareholders' consents. The consent distribution equals the aggregate of all the amounts specified in the several consents, whether or not, if actually distributed, such amounts would have constituted in whole or in part a return of capital. Section 28 (a) (4) may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, consisting of 500 shares, 200 of which are owned by A, and 300 by B. On December 15, 1938, the corporation distributes to A $5 per share, or $1,600. On December 31, 1938, B executes a consent to include $1,500 in his gross income as a taxable dividend. For the taxable year 1938 the earnings or profits are $2,600. Nevertheless the corporation will be deemed to have made a consent distribution of $1,500 on December 15.
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 $2 per share, or another class of consent stock $3 per share, or both classes of consent stock. Class A, with a par value of $40 per share, is entitled to one-third of any distribution made 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.

Example (2): The Y Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock, each a complete discharge of the obligation of the corporation to pay such dividends. For what constitutes payment of a dividend, and if cumulative, for prior taxable years, the corporation receives no credit for dividends paid in consequence thereof.

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1938, 1,000 shares of class A stock, the dividend rights of which are limited to an annual return of $5 per share. On April 1, 1938, this 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 distribution of earnings and profits by 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.

Example: The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock $2 per share, or another class of consent stock $3 per share, or both classes of consent stock.

Example (1): The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock $2 per share, or another class of consent stock $3 per share, or both classes of consent stock. Class A, with a par value of $40 per share, is entitled to one-third of any distribution made 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.

Example (2): The Y Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock, each a complete discharge of the obligation of the corporation to pay such dividends. For what constitutes payment of a dividend, and if cumulative, for prior taxable years, the corporation receives no credit for dividends paid in consequence thereof.
however, regardless of the fact that such amounts are treated and taxed in their entirety to the shareholders as a dividend (see section 28 (f)), be smaller than the sum of the specified amounts, because it is limited to the amount which would have been allowed as dividends paid if an actual distribution had been made.

The provisions of section 28 (c) may be illustrated by the following example: Example: The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year. Its earnings and profits for the calendar year 1938 amount to $8,000, there being at the beginning of the year 1938 no accumulated earnings or profits. A and B execute proper consents to include $8,000 each in their gross income as a dividend received by them on December 31, 1938. The sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X Corporation on December 31, 1938, only $8,000 would have constituted a dividend. The allowance for dividends paid, includible in the computation of the basic surtax credit, would have amounted to only $8,000. The consent dividends credit of the corporation, therefore, is limited to $8,000.

[Sec. 28, Consent dividends credit.] (d) Shareholders.—The corporation shall not be entitled to a consent dividends credit with respect to any taxable year—

1. Unless it files its return for each year (in accordance with regulations prescribed by the Commissioner with the approval of the Secretary) signed consents made under oath by persons who were shareholders, on the last day of the taxable year of the corporation, of any class of consent stock; and

2. Unless in such consent the shareholder, the corporation, and the person making the declaration of the amount included in the consent dividends credit, 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 each of the shareholders and the amounts 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

(C) Unless in each consent made by a shareholder who is taxable with respect to a dividend only if received from sources within the United States, such shareholder agrees that the specific amount stated in the consent shall be considered as a dividend received by him from sources within the United States.

[Sec. 29, Consent dividends credit.] (e) Consent distribution as part of entire distribution.—If during the last month of the taxable year, in which or with which the taxable year of the corporation ends, the corporation makes a consent distribution and a partial distribution are to be considered as having been made during the taxable year to shareholders, and giving all the other information required by the form.

In the event that any consent filed by the corporation is made by a shareholder in the payment to whom of a dividend in cash, on the last day of the taxable year of the corporation, the corporation would have been required to deduct and withhold any amount as a tax under section 143 (b) or 144, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(a) cash;

(b) United States postal money order;

(c) certified check drawn on a domestic bank, provided that the law of the place where the checking 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.

[Sec. 28, Consent dividends credit.] (d) Consent distribution must be nonspecial.—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, 1939, the corporation distributes $500 to A and $1000 to B. On December 31, 1939, 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 $500 and the consent distribution of $500 are preferential, when considered together they constitute a single nonpreferential distribution of $1,000.

[Sec. 23, Consent dividends credit.] (c) Consent distribution as part of entire distribution.—If during the last month of the taxable year, in which or with which the taxable year of the corporation ends, the consents filed by the corporation under subsection (d) there is made a partial distribution, then, for the purpose of this title, such partial distribution and the consent distribution shall be considered as having been made during the taxable year within the United States, shall be considered as having been made during the taxable year within the United States, and shall be considered together with the other parts of any entire distribution.

Annex 28 (d).—1. Consent and partial distributions to be considered together.—The rule provided in section 28 (e), that a consent distribution and a partial distribution are to be considered as having been made in connection with each other and as together forming parts of one entire distribution, is not limited to the purposes of section 28, but is applicable in connection with any of the purposes of Title I. Thus, such rule is to be applied to determine whether a partial distribution is a preferential dividend under section 27 (a). See article 27 (b) (1).

[Sec. 23, Consent dividends credit.] (f) Taxability of amounts specified in consents.—The total amount specified in a consent filed by a shareholder may be included as a taxable dividend in the gross income of the shareholder making such consent, and, if the consent distribution is made during the taxable year 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 includes it in his return; and

2. Whether the distribution by the corporation of an amount equal to the sum $500 and $1000 respectively, and $500 and $1,000 respectively, be considered as having been made during the taxable year within the United States, and be included in the computation of the tax of a shareholder, regardless of any consent dividends credit by reason of
the filing of such consents, or to a credit less than the total sum included in all the consents filed.

Art. 28 (f)–1. Taxability of amounts specified in consents.—Once a share-
holder’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; re-
gardless of—

(1) whether he actually so includes it in his return;

(2) whether he would have been taxable on all or any part of such amount as a dividend if it had been distributed to him in cash; and

(3) whether the corporation, as a re-
sult 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 corpora-
tion does not affect the taxability to the 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 cor-
poration 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 con-
sent which has been filed is also tax-
able to him as a dividend though a con-
sent dividends credit is denied the cor-
poration because (a) preferred dividends have not been paid, (b) part or all of the consent stock has been in a state of liquidation any time during the taxable year, (a) the distribution of which the consent distribution is a part is preferential, (d) a consenting share-
holder 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 con-
sent shall be considered as a dividend re-
cived by him from sources within the United States, or (e) payment has not been made as required by section 28 (d) and article 28 (d)–1.

[Sec. 28, Consent dividends credit.]

(a) Corporate shareholders.—If the share-
holder who makes the consent is a corpora-
tion, the amount specified in the consent shall be part of its earnings and profits for the taxable year, and shall be included in the computation of its accumulated earnings and profits.

Art. 28 (g)–1. Treatment of amount specified in consent of corporate share-
holder.—From the standpoint of com-
puting a shareholder’s income for a tax-
able year relative to which he has agreed to include a specific amount in gross in-
come, such amount is treated exactly as though such shareholder had received in cash a taxable dividend equal to the amount specified in his consent. There-
fore, in the case of a corporate share-
holder, such amount shall be included in the corporation’s taxes for the taxable year and its ac-
cumulated earnings and profits as of the close of the taxable year. The effect of a corporate shareholder’s consent upon the computation of its earnings and profits may be illustrated as follows:

Example: The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1938 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1939 amount to only $8,000, there being at the beginning of the year 1938 no accumulated earnings or profits. The Y Corporation must never-
theless include in its gross income $10,000 as a taxable dividend. Assume the Y Corporation to have begun the taxable year 1938 with $5,000 in earnings and profits, to have made no dis-
tributions during the year, and (with-
out 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.]

(b) Basis of stock in hands of sharehold-
ers.—The amount specified in a consent made under subsection (d) shall, for the purpose of adjusting the basis of the con-
sent stock with respect to which the con-
sent was given, be treated as having been reinvested by the shareholder as a contrib-
ution 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 share-
holder’s consent stock bears to the total amount of consent stock with respect to which consents are made.

(i) Effect on capital account of corpora-
tion.—The amount of the consent dividends credit allowed under subsection (c) shall be considered in part as a contrib-
ution to the capital of the corporation, and the accumulated earnings and profits as of the close of the taxable year shall be corre-
spondingly reduced.

Art. 28 (h)–1. Effect on basis of stock in hands of shareholders and capital ac-
count 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 cal-
endar 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 in-
come as a dividend, but B refuses to do so. The X Corporation therefore dis-
tributes $50 to A in cash during the last month of its taxable year 1938. The consent distribution evidenced by A’s consent and the actual distribution to B are treated together, as though one dis-
tribution of $100 had been made. The earnings and profits of the X Corpora-
tion for 1938, however, amount to only $80, there being at the beginning of the year 1938 no accumulated earnings or profits. If, therefore, the entire $100, which is the sum of A’s consent distribution and B’s actual distribution, had been actually distributed, 80 percent thereof would have been a dividend, in-
cludible 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 Corpora-
tion—

(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 preced-
ing year and no bank affiliate credit, is $80, composed of a consent dividends credit of $40 and an allowance for divi-
dends 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 con-
sent dividends credit) from earnings and profits to capital account and the deduc-
tion of an additional $40 on account of dividends paid to B. If, therefore, in the follow-
ing year the X Corporation has no earnings and profits but never-
theless makes a distribution to share-
holders, 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.]

(f) Amounts not included in shareholder’s return.—The failure of a shareholder of con-
sent 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 57 (f) with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

CHAPTER VI

Credits Against Tax

Part III—Credits Against Tax

Sec. 31. Taxes of foreign countries and possessions of United States.—The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax, to the extent provided in section 131.

Sec. 32. Taxes withheld at source.—The amount of tax withheld at source under section 143 or 144 shall be allowed as a credit against the tax.

Sec. 33. Credit for overpayments.—For credit against the tax of overpayments of taxes imposed by this title for other taxable years, see section 322.
CHAPTER VII
Accounting Periods and Methods

Part IV—Accounting Periods and Methods of Accounting

§ 41. General rule.—The net income shall be computed upon the basis of the taxpayer’s annual period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed by him in computing such income, 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 the method as in the opinion of the Commissioner best serves and not to current expenses.

The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return.

If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who desires to change the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this article, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories; a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the method of treated as an expense account; and any special provisions relating to the payments due on installment contracts as of the close of the preceding taxable year.

§ 42. Methods of accounting.—It is recognized that no single 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 hereby required to keep a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so.

Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, buying, selling, or conversion of the merchandise in hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and in computing the net income of the year (see section 22 (c) and articles 22 (c)–8) and article 22 (c)–8; and on the other hand, appreciation in value should be taken at the beginning and end of the year and the gain should be treated as income; and all amounts duplicated or entirely omitted shall be included in the net income at the beginning of the year;

(2) Capital 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 in which they are made, should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depreciation, 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.

§ 43. 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 42). 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 account-
ing 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 his fiscal year except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. See article 46-1.

Sec. 42. Period in which items of gross income included.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer, there shall be included in computing net income for the taxable year in which falls the date of his death, amounts accrued up to the date of his death, if otherwise property included in respect of such period or a prior period.

Art. 42-1. When included in gross income.—Except as otherwise provided in sections 41-1 to 41-3, the gross income of the decedent includes the gain accruing to the taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See articles 41-1 to 41-3.) If a taxpayer has died there shall also be included in computing net income for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, regardless of the fact that the decedent may have kept his books and made his returns on the basis of such receipts and disbursements. If no determination of compensation is had until after 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 receivables 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 included in 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 by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See article 23 (k)-1.) Such items as claims for compensation under canceled Government contracts constitute income for the year in which income therefrom is determined, if the return is rendered on the accrual basis; or, for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

Art. 42-2. Income not reduced to possession.—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart and not actually reduced to possession. To constitute receipt in such 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 time or a period of one accounting year to another. If a corporation continuously credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

Art. 42-3. Examples of constructive receipt.—If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. The amount of defaulted coupons is income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. If a dividend is declared payable on December 31 and the corporation through 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 there may be no bank policy normally 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 the approval of the board of directors, has a taxable status as income for the year of the credit. If the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

Art. 42-4. Long-term contracts.—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature of the particular contract. As used in this article the term “long-term contracts” means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are allocable thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this article only after permission is secured from the Commissioner as provided in article 41-2.

Art. 42-5. Subtraction for redemption of trading stamps.—If a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will be required to pay the broker’s commission. This amount will be determined in the light of the experience of the tax-
payer 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, at 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 or percentage of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

Sec. 43. Period for which deductions and credits taken.—The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which the taxpayer has the right to deduct such loss or paid or accrued, or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death (except deductions under section 23 (o) if not otherwise properly allowable in respect of such period or a prior period.

Ann. 43-1. "Paid or incurred" and "paid or accrued."—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) shall be taken for the taxable year in which paid or accrued, or paid or incurred, unless in order to clearly 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 return with the statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually paid or incurred, or paid or accrued, as the case may be.

Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

(b) The provisions of paragraph (a) of this article in general are not applicable with respect to the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount or percentage of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

Sec. 44. Installment basis.—(a) Dealers in personal property.—Under regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury, a person who regularly calls on or otherwise deals in personal property or on the installment plan may return income to be included in his income for the taxable year in which the installment payments are actually received and not includible in income for the taxable year in which the installment payments are actually made, provided for the year in which the installment is completed, bears to the total contract price.

(c) Sales of realty and personal property.—In the case of (1) a casual sale or other casual disposition of personal property, other than property acquired as a capital asset, the gain or loss thereon would properly be included in the inventory of the taxpayer in the year in which it was acquired or to which the property is attached, or in the calendar year in which the proceeds of such sale or disposition are included in the income of the taxpayer. If in either case the installment payments do not complete the sale or disposition by the date of the closing sale (or, in the case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the closing price prescribed in the law applicable to each year), the income may, under regulations prescribed by the Commissioner, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payment" means the payment made for personal property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

(d) Change from accrual to installment basis.—If on or after December 31 of a taxable year the taxpayer elects to change from the method of accounting for such taxable year to the method of accounting upon the basis of which the installment payments are to be computed, he shall deduct all or any portion of such damages as may have been computed or other cause, are deductible from gross income when the claim is so adjudicated income for the year in which sustained.

(e) Sales of realty and personal property.—In the case of a sale of real property, other than property acquired as a capital asset, the gain shall be included in the sale price of the property the year in which the sale is completed or the personal property is delivered, or the contract is discharged, and so long as such property is not deductible for the year in which it was acquired, or to which the property is attached, or in the calendar year in which the proceeds thereof are included in the income of the taxpayer. If in either case the installment payments do not complete the sale or disposition by the date of the closing sale (or, in the case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the closing price prescribed in the law applicable to each year), the income may, under regulations prescribed by the Commissioner, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payment" means the payment made for personal property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.
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, which remains in the hands of 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 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 derived from the property, provided that they were received under a sale in which 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. Deductions from income are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued," as provided by sections 43 and 48. A dealer who desires to compute his income on the installment basis shall maintain books of account in such a manner as to enable an accurate computation to be made on such basis in accordance with the provisions of this article.

The income from a casual sale of 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 is 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 investor 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 of the property in the hands of the vendor of the obligations which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also article 44-5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession, unless it is clearly shown that 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 which the repossession occurs, whether or not the purchaser remained liable after the repossession. (See also article 23 (k)-1.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price, in the absence of clear and convincing proof to the contrary. The property repossessed shall be carried on the books of the vendor at its fair market value at the time of repossession.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible. Ann. 44-2. Sale of real property involving deferred payments.—Under section 44 deferred-payment sales of real property included in the term "installment plan" mean payments not to be made for bears to the total contract price.
If the purchaser defaults in any of his payments, and the vendor returning in connection with the reacquisition or bid price for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be as the original basis at the time of the sale plus the fair market value at the time of repossession, of fixed improvements placed on the property by the purchaser. If the vendor has previously transferred title to the purchaser, and the purchaser defaults in any of his payments and the vendor reacquires the property, such reacquisition shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser’s obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of reacquisition, measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis of the property in the hands of the vendor 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. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired and the reacquisition or installment obligations of the purchaser which are satisfied or discharged.

Art. 44-4. Deferred-payment sale of real property not on installment plan.— In transactions included in class (2) in article 44-2, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to ascertain the amount of their fair market value in the transaction.

The vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor reacquires the property and the differences between (1) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value of the property at the time of repossession of fixed improvements placed on the property by the purchaser and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaust, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser, or the vendor, for the year in which the property was reacquired by him in connection with the reacquisition or bid price of the property, the vendor for the year in which the property was reacquired, or the vendor for the year in which the property was reacquired and the property was reacquired by the vendor for the year in which the property was reacquired shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser’s obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of reacquisition, measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis of the property in the hands of the vendor 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. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired and the reacquisition or installment obligations of the purchaser which are satisfied or discharged.

Art. 44-5. Gain or loss upon disposition of installment obligations.— The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the Act, unless the disposition is within one of the exceptions made by the Act. Such an exception is provided in section 44 (d) with respect to distributions under section 112 (b) (1) and (6), and in section 112 (b) (4) and (6) with respect to exchanges.

The application of subsection (d) of section 44 may be illustrated by the following examples:

Example (1): In 1938 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 the years 1925 and 1926 the company received $5,000 cash and vendor’s notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1938, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1938 is $5,500, computed as follows:

| Proceeds of sale of notes            | $13,000 |
| Selling price of property           | $20,000 |
| Cost of property                    | $10,000 |
| Total profit                        | $10,000 |
| Total contract price                | $20,000 |
| Percent of profit, or proportion of cash payment returnable as income | 50% |
| Face value of notes                 | $15,000 |
| Amount of income returnable         | $7,500 |
| Face value of notes                 | $15,000 |
| Excess of face value of notes over amount of income returnable         | $7,500 |

Taxable income to be reported for 1938

Example (2): Suppose in the example given above the M Corporation, instead of selling the notes, distributed them to B in 1933 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 1933 is $5,500, computed as follows:

| Face value of notes                 | $14,000 |
| Excess of face value of notes over amount of income returnable         | $7,500 |
| Taxable income to be reported for 1933                                  | $5,500 |

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

FEDERAL REGISTER, Friday, February 10, 1939 679

HeinOnline -- 4 Fed. Reg. 679 1939
have been limited to 50 percent thereof by section 117 (b), the real estate having been held for more than 24 months prior to its sale in 1936. See also section 117 (c).

In the case of decedents who die possessed of installment obligations, no gain on account of the transmission at death of such obligations is required to be reported as income in the return of the decedent for the year of his death, if the executor or administrator of the estate of the decedent or any of the next of kin or legatees files with the Commissioner a bond on Form 1132 in an amount not less than the amount by which the tax of the decedent for the year of his death would have been increased had no such bond been filed. The bond shall be conditioned upon the return as income, by any person receiving any payment in satisfaction of such obligations, of the same proportion of such payment as the net income of the decedent would have been had he lived and had received such payment. The bond shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, shall be subject to the approval of the Commissioner, and must be filed at the time of filing the return of the decedent for the year of his death. See section 1126 of the Revenue Act of 1936, as amended (paragraph 35 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States.

See section 117 as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

Sec. 45. Allocation of income and deductions.—In any case of two or more organizations, trades, or businesses (whether or not incorporated or 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 to clearly reflect the income of any of such organizations, trades, or businesses.

Art. 45-1. Determination of the taxable net income of a controlled taxpayer.—(a) Definitions.—When used in this article—

(1) The term “organization” includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Act or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms “trade” or “business” include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term “controlled” includes any kind of control, direct or indirect, whether exercised or nonexercisable, 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,” in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting such 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, arrangement, the controlled taxpayer, or the intercorporate distribution 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 this section 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 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 such income or deductions, among the controlled taxpayers constituting the group, determine the true net income of each controlled taxpayer.

The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.

Section 45 and this article apply to the case of any controlled taxpayer, whether such taxpayer makes a separate return 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 any case involving 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 the computation of net income under a consolidated return, but is, or in 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 under this paragraph extends to any case in which there is any device by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, or 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, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 47.

Art. 46-1. Change in accounting period.—If a taxpayer changes his accounting period from fiscal year to calendar 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.
third month following the close of that period. If the change is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. (See section 47.)

Section 47. Returns for a period of less than twelve months.—If a return for a fractional part of a year is required, the tax return for such fractional part of a year shall be made on the basis of the period for which the return is made. If the taxpayer is a corporation, the Commissioner shall have authority to require a return for a fractional part of a year, except where such return is made for a period of less than 12 months by reason of a change in the accounting period, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the period for which the return is made bears to 12 months.

In case of a change in accounting period the net income computed on the return for the fractional part of a year (except the return of a corporation) shall be placed on an annual basis and the tax computed as provided in section 47 (c).

Example: A citizen of the United States made a return for a 10-month period by reason of a change in accounting period. His net income including his earned net income for such 10-month period was $10,000, and his earned net income for such period was $4,000. He was entitled to a personal exemption of $2,500 but not to a credit for dependents. His tax for the period is $258.97, computed as follows:

Net income for 10-month period: $10,000.00
Multiplied by 12: $120,000.00
Less: Personal exemption: $2,500.00
Net income subject to normal tax: $117,500.00
Normal tax (4 percent of gross income): $4,700.00
Less: Surtax on normal tax ($12,000 less personal exemption of $4,000): $4,700.00
Surtax on $9,500: $326.80
Total tax on normal tax basis ($263,80+4,700): $326.80
Amount of tax for period ($580,00+10): $265.87
The return of a decedent or of his estate in the case of a husband and wife.—In the case of a husband and wife, the income of each shall be computed on the aggregate income, whether or not such citizen or resident of the United States is a United States citizen or resident.
(a) having for the taxable year a gross income (as defined in sections 22 and 116) of $5,000 or over (regardless of the amount of the net income); or
(b) having for the taxable year a net income (as defined in section 21) of $1,000 or over.

(2) If married and living with husband or wife for the entire taxable year, if no joint return is made, and if—
(a) having for the taxable year a net income of $2,500 or over or a gross income of $5,000 or over (regardless of the amount of the net income), and the other spouse has no gross income; or
(b) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate net income of the two is $2,500 or over; or
(c) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate gross income is $5,000 or over.

(3) If married and living with husband or wife for any part of the taxable year, if not at the close thereof, or if married and living with husband or wife at the close of the taxable year, but not during the entire taxable year, if no joint return is made, and if—
(a) having for the taxable year a net income equal to, or in excess of, the credit allowed him or her by section 25 (b) (1) and (3) (computed without regard to any credit to which he or she may be entitled as the head of a family (see article 25-7)); or
(b) Joint returns.—A husband and wife, if living together at the close of the taxable year, may elect to make a joint return (see section 51 (b)), that is, to include in a single return made by them jointly the income and deductions of each, even though one has no gross income. In such a case, the tax shall be computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year. A joint return may not be made if either the husband or wife is a nonresident alien.

A joint return of a husband and wife (if not made by an agent other than husband or wife, see article 51–2) shall be signed by both spouses, except that one spouse may sign the return as the agent for the other. If the return is accompanied by a power of attorney on Form 936, authorizing such action. The spouse acting as agent shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

The joint return of a husband and wife shall be sworn to before a person duly authorized to administer oaths (see section 936), that is, any United States officer or employee of the Government who administers oaths in his official capacity, and who is authorized by law to administer oaths for the purposes of those return (see article 25-7). The return shall be considered to have prepared the return within the meaning of this paragraph. If the return is prepared by both spouses, or is prepared by neither spouse, then both spouses shall swear to the return, except where one spouse acts for the other under a power of attorney submitted on Form 936, or the return is made by an agent by reason of illness or absence, as provided in article 51–2.

For returns by fiduciaries, see section 936; by partnerships, see section 187; and by nonresident alien individuals, see section 217. For time and place for filing returns, see section 53.

Art. 51-2. Form of return.—The return shall be on Form 1040 except that it shall be on short Form 1040 if (1) the net income does not exceed $5,000, and is derived solely from interest, dividends, rents, business income, wages, salaries, commissions, bonuses, and other compensation for personal services, and (2) the taxpayer does not own a business or practice a profession on his own account and renders a return on the cash receipts and disbursements basis for the calendar year. The return shall be made on Form 1040 in all cases in which the taxpayer claims any deductions for losses from the renting of, or sale or exchange of, property. The returns may be had from the collectors of the several districts in the United States, by the agent of any person dying, who is a resident of the United States, by any person duly authorized to administer oaths for general purposes by the law of any State or of any territory 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 by any officer having knowledge of the appointment and official character of the attesting officer. If a foreigner has been naturalized or otherwise become a citizen of the United States, the return may be made to any collector of internal revenue, in which case it shall be accompanied with the prescribed power of attorney, Form 936. If he is married, see article 51-2. If under the laws of any State the earnings of a minor belong to the minor, such earnings, except such part as is required to be included in the return of the parent. In the absence of proof to the contrary, a parent will be presumed to have the legal right to the earnings of the minor and must include them in their return.

Art. 51-4. Verification of returns.—(a) All income tax returns must be verified under oath or affirmation. The oath or affirmation shall 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 office authorized to administer oaths for the purposes of the respective services. Income tax returns executed abroad may be attested free of charge before United States consular officers. If a foreigner notary or other foreign officer having no seal should not as an officer of the United States, he shall be certified to by some judicial officer or other proper officer having knowledge of the appointment and official character of the attesting officer.

(b) If any person or persons actually prepare an income return for another person, the prescribed form of affidavit on the return shall be subscribed and
taxpayer should carefully prepare his return so as finely and clearly to set forth the data therein called for. Returns which have been so prepared will not be accepted as meeting the requirements of the Act. In lieu of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a return if given to the Collector within the prescribed time the statement so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form. (See further articles 53-2 to 53-4.)

Sect. 52. Corporation returns.—Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer, assistant treasurer, or chief accountant. In carrying on its operations, trustees, trustees in bankruptcy, or assignees are operating the property or business of corporations, the corporation shall make returns for such corporations; in the same manner and form as corporations required to make returns by 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 whose business or property they have custody and control.

Sect. 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) Extensions of time.—The Secretary 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 of time shall exceed three months.

(b) To whom return made.—(1) Individual.—Returns (other than corporation returns) shall be made to the Collector at Baltimore, Maryland, or at the address of the Secretary. (2) Corporations.—Returns of corporations shall be made to the Collector at the address of the Secretary. (3) Corporations.—Returns of corporations shall be made to the Collector at the address of the Secretary.

Ann. 52-1. Corporation returns.—Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120 or Form 1120A. For returns of insurance companies, see articles 201 (b)–1, 204 (a)–1, and 207–4; of foreign corporations, see section 253; and of affiliated corporations, see articles 141–1. A corporation having an existence during any portion of a taxable year is required to make a return. A corporation which has received a charter, but has not 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 contrary, such a corporation is required to make a return. A corporation which was dissolved in 1938 prior to the enactment of the Revenue Act of 1938 is not relieved from the necessity of rendering returns thereafter for any period or periods of its existence for which the return is effective. For returns by corporations contemplating dissolution or liquidation, see section 148 (d). For information returns by corporations of distributions in liquidation, see section 148 (e). For information returns by corporations relating to profits of the taxable year declared as dividends, see section 148 (b). For verification of returns and use of prescribed forms, see articles 51-4 and 51-5.

Ann. 52-2. Returns of receivers.—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in actual possession of the property and control. (See articles 274–1 and 274–3.)

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.

Ann. 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) Extensions of time.—The Secretary 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 of time shall exceed three months.

(b) To whom return made.—(1) Individual.—Returns (other than corporation returns) shall be made to the Collector at Baltimore, Maryland, or at the address of the Secretary. (2) Corporations.—Returns of corporations shall be made to the Collector at the address of the Secretary. (3) Corporations.—Returns of corporations shall be made to the Collector at the address of the Secretary.
year covering its income for the part of the year during which it was engaged in business, and may immediately file such return with the collector. See also section 148 (d) and (e).

Art. 53-2, Extensions of time for filing returns.—It is important that the taxpayer render on or before the due date a return which is as nearly complete and final as 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 at the time filed, for filing income tax returns may be granted for more than six months. For extensions of time for payment of tax, see sections 55 (e) and 272 (1) and articles 55-2, 55-3, 272-3.

Art. 53-3, Extensions of time in the case of foreign organizations, certain domestic corporations, and citizens of United States residing or traveling abroad.—An extension of time for filing returns of income for taxable years begun after December 31, 1937, is hereby granted up to and including the 15th day of the sixth month following the close of the taxable year in the case of:
(a) Foreign partnerships regardless of whether they maintain an office or place of business within the United States;
(b) Foreign corporations which maintain an office or place of business within the United States;
(c) Domestic corporations which transact their business and keep their records and books of account abroad;
(d) Domestic corporations whose principal income is from sources within the possessions of the United States and from American citizens residing abroad, including persons in military or naval service on duty outside the United States.

In all such cases an affidavit must be attached to the return, stating the cause of the delay in filing.

Taxpayers who take advantage of this extension of time will be charged with interest at the rate of 6 percent per annum on the first installment of tax from the original due date until paid.

Art. 53-4, Due date of return.—The due date of a return as nearly complete and final as is possible for him to prepare is the last day of the period covered by the extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the last day of the period 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 collector 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 envelopes in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

Art. 52-5, 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 income tax forms.—(a) By taxpayer.—Every person required to pay any tax imposed by this title or for the collection thereof, shall sign and affix his name to, under oath, such statement and return, 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 statement, return, and comply with such rules and regulations, the Commissioner deems sufficient to show whether such person is liable to tax under this title.

(c) Information at the source.—For requirements as to 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 to render periodic statements and returns by the person to assist in determining the tax liability of another person, see sections 147 to 150.

(e) Copies of returns.—If any person, required by law to render periodic statements and returns by the person to assist in determining the tax liability of another person, see sections 147 to 150.

(f) Copies of returns.—If any person, required by law to render periodic statements and returns by the person to assist in determining the tax liability of another person, see sections 147 to 150.

(g) Copies of returns.—If any person, required by law to render periodic statements and returns by the person to assist in determining the tax liability of another person, see sections 147 to 150.

(h) Copies of returns.—If any person, required by law to render periodic statements and returns by the person to assist in determining the tax liability of another person, see sections 147 to 150.

Sec. 55. Publicity of returns.—(a) Returns made under this title shall be open to inspection in the same manner, to the same extent, and subject to the same provisions of law, including penalties, as returns made under Title II of the Revenue Act of 1929; and all returns made under this Act shall constitute public records and shall be open to public examination and inspection to such extent as shall be authorized in rules and regulations promulgated by the President.

(b) All income returns filed under this title shall be kept in the possession of the collector, and shall be secured and safeguarded by regulations made under this subsection, shall be open to inspection by any official, commissioner, or employee of the administration of any State tax law, if the inspection is for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in paragraph (a). The inspection shall be permitted only upon written request of the Governor of such State, designating the representative 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.

(c) Any information thus secured by any official, body, or commission of any State shall be secure from disclosure in violation of the tax laws of such State, except that upon request of the Governor of such State any information may be furnished to any official, body, or commission of such State, lawfully charged with the administration of the tax laws of such political subdivision, but may be used only for the purpose of, and may be used only for,
the administration of such tax laws. Any officer, employee, or agent of any State or political subdivision, who divulges (except as authorized, or called upon to testify in any judicial or administrative proceeding to which the State or political subdivision, or State or local official, body, or commission, as such, is a party) any information acquired by him through the inspection, or another under this subsection shall be guilty of a misdemeanor and shall upon conviction be fined $600 or more than one year, or both.

Art. 55 (b)–1. Definitions.—Any word or term used in this article and articles 55 (b)–2 to 55 (b)–5, inclusive, which is defined in the Act shall be given the respective definitions contained in the Act.

Art. 55 (b)–2. Copies of income returns.—Every person (except nonresident alien individuals, nonresident alien fiduciaries, nonresident foreign partnerships, and nonresident foreign corporations) required to file an income return (and referred to in this title as the "taxpayer") is a party (except those referred to in this title as the "taxpayer") any information acquired by the Commissioner or by any representative of such official, body, or commission is charged with administering or for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in section 55 (b) (2). The governors of the respective States shall be notified by the Commissioner of the date the copies of returns provided for in subsection (d) of section 55 (d) (1) are opened for inspection and inspection thereof shall not be permitted after one year from such date.

Art. 55 (b)–4. Request for permission to inspect copies.—Requests for permission to inspect the copies of returns must be in writing signed by a duly authorized representative of such official, body, or commission, designated by the official, body, or commission to be furnished to local taxing authorities as provided in section 55 (a) (6) and (f), or (as the case may be) to local taxing authorities as provided in section 55 (a) (6) and (f), or (as the case may be) to the persons authorized to make such inspections. The request must state (a) the kind of returns it is desired to inspect, (b) the taxable year or years covered by the copies of returns it is desired to inspect, (c) the name of the official, body, or commission by whom or through which the inspection is to be made, (d) the name of the representative of such official, body, or commission, designated by the official, body, or commission to be furnished to local taxing authorities as provided in section 55 (a) (6) and (f), or (as the case may be) to local taxing authorities as provided in section 55 (a) (6) and (f), or (as the case may be) to the persons authorized to make such inspections. The request must state (1) the name of the official, body, or commission by whom or through which the inspection is to be made and (2) the purpose for which the information is to be used. The request must be signed by a duly authorized representative of such official, body, or commission designated in writing in the name of the official, body, or commission.

Art. 55 (b)–5. Inspection of original returns.—Upon request of copies of returns provided for in article 55 (b)–3, any properly authorized official, body, or commission, lawfully charged with the duties of such political subdivision, if any, to whom or to which the information secured by the inspection is to be furnished, and (2) the purpose for which the information is to be used by such official, body, or commission.

Art. 55 (b)–7. Payment of tax.—The tax on the total amount of the tax (as defined in this title) shall be paid on the date prescribed for the payment of the tax by the taxpayer, or any installment thereof, for a period not exceeding five years from the date prescribed for the payment of the tax or any installment thereof. In such cases 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.

Section 56. Payment of tax.—(a) Time of payment.—The tax or any installment thereof shall be paid on the fifteenth day of the month in which the tax is due, or on or before the date of the expiration of the period of the extension.

(b) Installment payments.—The taxpayer may elect to pay the tax in four equal installments on the fifteenth day of the month in which the tax is due, or on or before the date of the expiration of the period of the extension.

Art. 56 (b)–1. Payment of tax.—The tax on the total amount of the tax (as defined in this title) shall be paid on the date prescribed for the payment of the tax by the taxpayer, or any installment thereof, for a period not exceeding five years from the date prescribed for the payment of the tax or any installment thereof. In such cases 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.

(b) Installment payments.—The taxpayer may elect to pay the tax in four equal installments on the fifteenth day of the month in which the tax is due, or on or before the date of the expiration of the period of the extension.

Art. 56 (b)–7. Payment of tax.—The tax on the total amount of the tax (as defined in this title) shall be paid on the date prescribed for the payment of the tax by the taxpayer, or any installment thereof, for a period not exceeding five years from the date prescribed for the payment of the tax or any installment thereof. In such cases 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.

Section 56. Payment of tax.—(a) Time of payment.—The tax or any installment thereof shall be paid on the fifteenth day of the month in which the tax is due, or on or before the date of the expiration of the period of the extension.

(b) Installment payments.—The taxpayer may elect to pay the tax in four equal installments on the fifteenth day of the month in which the tax is due, or on or before the date of the expiration of the period of the extension.
(e) Advance payment in case of jeopardy.—For advance payment in case of jeopardy, see § 56-2.

(f) Tax withheld at source.—For requirement of withholding tax at the source in the case of nonresident aliens and corporations, and in the case of so-called "tax-free covenant bonds", see sections 143 and 144.

(g) Fractional parts of cent.—In the payment of any tax under this title a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Art. 56-1. Date on which tax shall be paid.—The tax, unless it is required to be withheld at the source (see sections 143 and 144) or unless it is to be paid by a nonresident alien individual (see section 218) or a foreign corporation not having any office or place of business in the United States (see section 236), is to be paid on or before the 15th day of March following the close of the calendar year, or, if the return is made on the basis of a single payment on or before the 15th day of the third month following the close of such fiscal year. But see article 53-3. The tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, subject to the approval of the Commissioner, in cash, check, or money order the canceled check or the money order receipt. In the case of taxes which are payable, in whole or in part, by check or money order receipt, the amount of such tax shall be increased to 1 cent. Fractions of a cent not equal to one-half cent should not be disregarded.

Art. 56-2. Extension of time for payment of the tax or installment thereof.—If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof is impossible or impractical, or that the Commissioner is unable to examine the return, the Commissioner may, in the discretion of the Commissioner, upon the request of the taxpayer, grant an extension of time for the payment of the tax or installment thereof, or of any part or installment thereof, not exceeding 6 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 5 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 sale of property other than money upon the complete liquidation (as defined in section 115 (c) of a corpora-
tion) or if the tax for the 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 due on or before the date prescribed for such payment. An application for an extension of time for the payment of such tax should be made in writing and should set forth in detail the reasons why, in the opinion of the taxpayer, an extension should be granted, and the amount, time for payment of which is to be extended, shall be paid on or before the expiration of the period of the extension. When it is received, 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, or 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 executed in such manner as the Commissioner shall determine, 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 one or more letters of credit issued by a bank or trust company, to the approval of the Commissioner. See section 1125 of the Revenue Act of 1926, as amended, paragraph 28 of the Appendix to these regulations.) A request by the taxpayer for an extension of time for the payment of one installment does not operate to procure an extension of time for payment of subsequent installments. Nor does an extension of time for filling 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 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.

Art. 56-3. When fractional part of cent may be disregarded.—In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Art. 56-4. Receipts for tax payments.—Upon request a collector will give a receipt for each tax payment or the canceled check or money order receipt. In the case of taxes which are payable, in whole or in part, by check or money order receipt, the amount of such tax shall be increased to 1 cent. Receipts for tax payments made by check or money order the canceled check or the money order receipt is usually a sufficient receipt. In the case of taxes in cash, however, the taxpayer should in every instance require and the collector should furnish a receipt.

Art. 57. Examination of return and determination of tax.—As soon as practicable after the return is filed the Commissioner shall examine it and shall determine the correct amount of the tax.

Art. 57-1. Examination of return and determination of tax by the Commissioner.—As soon as practicable after returns are filed, they will be examined, and the correct amount of the tax determined under such procedure as may be prescribed from time to time by the Commissioner. (See section 272.)

Art. 58. Additions to tax and penalties.—
(a) Additions to tax and penalties.—For additions to tax due to negligence or fraud in the nonpayment of tax or failure to file return thereof, see Supplement M.

(b) For criminal penalties for nonpayment of tax or failure to file return therefor, see section 145.

Sec. 59. Administrative proceedings.—For administrative proceedings in respect of the
nonpayment or overpayment of a tax imposed by this title, see as follows:

(a) Supplement I, relating to assessment and collection of deficiencies.
(b) Supplement M, relating to interest and additions to tax.
(c) Supplement N, relating to claims against transferees and fiduciaries.
(d) Supplement O, relating to overpayments.

CHAPTER IX
Miscellaneous Provisions

Part VI—Miscellaneous Provisions
Sec. 61. Laws made applicable.—All administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this title.
Sec. 62. Rules and regulations.—The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.
Sec. 63. Taxes in lieu of taxes under 1936 Act.—The taxes imposed by this title and Title IA shall be in lieu of the taxes imposed by Titles I and IA of the Revenue Act of 1936, as amended.

[Chapters X–XXXIII (Supplemental Provisions, Subtitle C of Title 1) will appear in the Federal Register for Saturday, February 11, 1939. Chapters XXXIV–XXXVIII and the Appendix will appear in the Federal Register for Tuesday, February 14, 1939.]

[SEAL] GUY T. HELVERING, Commissioner of Internal Revenue
Approved, February 7, 1939.
H. MORGENTHAU, Jr. Secretary of the Treasury.

[F. R. Doc. 39–450; Filed, February 7, 1939; 4:01 p. m.]

Notices

TREASURY DEPARTMENT.

Federal Alcohol Administration Division.

PURCHASING CAPITAL STOCK IN RETAIL CORPORATION

FEBRUARY 8, 1939.

To all Industry Members:

The Administration is in receipt of inquiries from the trade as to whether or not, under the Federal Alcohol Administration Act, industry members subject to the Administration’s jurisdiction may acquire and hold stock in a corporation engaged in business as a retail liquor dealer. In view of the fact that the acquisition of a part of the capital stock of a corporation engaged in retailing alcoholic beverages would automatically convey to the purchaser thereof an interest in the property of the retailor, the Administration has concluded that the provisions of section 5 (b) of the Federal Alcohol Administration Act would be applicable to such transactions.

It follows that if the acquiring or holding by such an interest operates to affect the purchasing policies of the retail corporation, in the manner proscribed by the statute, a violation of the statute would result.


[F. R. Doc. 39–466; Filed, February 8, 1939; 3:55 p. m.]

DEPARTMENT OF AGRICULTURE.

Agricultural Adjustment Administration.

1939 JONES COUNTY, SOUTH DAKOTA, RANGE CONSERVATION PROGRAM BULLETIN

CONTENTS

Section I. Range-Building Allowance.
II. Payment for Full Performance.
III. Conditions of Payment.
IV. Changes in Grazing Arrangements and Other Devices.
V. Eligibility for Payment.
VI. Payment Restricted to the Purpose of the Program.
VII. Payments Computed and Made Without Regard to Claim. VIII. Increase in Small Payments.
IX. Deductions for Association Expenses.

This bulletin sets forth provisions for continuing the special range conservation program administered in Jones County, South Dakota, in 1938 as the first of three years during which the program was designed to operate. That program prescribed “provisions for establishing an individual range-building goal to be attained as quickly as possible and at least by the end of three years, and yearly summative yearly goals which should be attained by the end of each respective year and which accumulate to equal the three-year range-building goal. Subject to the provisions of this bulletin and within the yearly range-building allowance, payment will be made for the attainment of these separate yearly goals. Goals in all cases include the retention of 20 percent of the annual growth of palatable forage at the end of the grazing season, the showing of performance of a designated quantity of practices listed in this bulletin, and may include at the discretion of the committee the performance of additional nonlisted range-building practices considered essential to the conservation of the range land in the ranching unit. All payments are contingent upon the attaining of the yearly cumulative goal; there is no provision for partial performance. For those ranches for which the number of units of listed practices in the cumulative goal for the year in question is no larger than the number of units of such practices in the cumulative goal for the previous year, a payment of 75 percent of the annual range-building allowance will be made, provided the requirements of the goal for that year are met.”

Pursuant to the authority vested in the Secretary of Agriculture under Sections 7 to 11, inclusive, of the Soil Conservation and Domestic Allotment Act (49 Stat. 1148), as amended, and in connection with the effectuation of the purposes of Section 7 (a) of said Act in 1939, payments will be made for participation in the 1939 Jones County Range Conservation Program in accordance with the provisions hereof and such modifications therof or other revisions as may hereafter be made.

The provisions of this program are necessarily subject to such legislation affecting said program as the Congress of the United States may hereafter enact; the making of the payments herein provided is contingent upon such appropriation as the Congress may hereafter provide for such purpose; and the amounts of such payments will necessarily be within the limits to be determined by such appropriation, the amount of such appropriation under the provisions of the Soil Conservation and Domestic Allotment Act, as amended, and such payments may be increased or decreased by not more than 10 percent, depending upon the extent of participation in the 1939 Range Conservation Program.

The provisions of the 1939 Jones County, South Dakota, Range Conservation Program contained in this Bulletin are not applicable (1) to counties other than Jones County, South Dakota, and (2) to public domain of the United States, and other lands in which the beneficial ownership is in the United States.

The provisions of this bulletin are to be reviewed in 1940 except in case the Agricultural Adjustment Administration finds that (1) the national range program has been modified in such manner as to adopt the essential provisions of the Jones County, South Dakota, Program or is otherwise modified in such manner as to indicate a continuation of the Jones County Program is unnecessary or undesirable, or (2) the resulting performance under this program has proven it is not administratively feasible, and that it is not contributing to the improvement of the national range program, or for other reasons indicates its continuation is undesirable, or (3) modifications of the Soil Conservation and Domestic Allotment Act, as amended, or the Agricultural Adjustment Act of 1938, as amended, are such as to prohibit its continuation, or are such as to indicate its continuation is not administratively advisable.

Section I. Range-building allowance.—The range-building allowance shall be $1.40 times the grazing capacity (expressed as animal units) of the range land in the ranching unit, provided, that this item shall not be calculated on more
WASHINGTON, Saturday, February 11, 1939

The President

EXECUTIVE ORDER

AUTHORIZING THE APPOINTMENT OF FREDERICK MORGAN DAVENPORT TO A CLASSIFIED POSITION IN THE CIVIL SERVICE COMMISSION AND DESIGNATING HIM AS A MEMBER AND CHAIRMAN OF THE COUNCIL OF PERSONNEL ADMINISTRATION

By virtue of and pursuant to the authority vested in me by paragraphs Eight, subdivision SECOND, section 2 of the Civil Service Act (22 Stat. 403, 404), and as President of the United States, it is hereby ordered that Frederick Morgan Davenport may be appointed to a classified position in the Civil Service Commission; and I hereby designate the said Frederick Morgan Davenport as a member and Chairman of the Council of Personnel Administration established by section 7 of Executive Order No. 7916 of June 24, 1939; such designation to become effective upon his acceptance of the appointment herein authorized.

FRANKLIN D. ROOSEVELT

THE WHITE HOUSE
February 8, 1939.

[No. 8045]

[F. B. Doc. 39-476; Filed, February 9, 1939; 2:49 p.m.]

Rules, Regulations, Orders

TITLE 16—COMMERCIAL PRACTICES

FEDERAL TRADE COMMISSION

[Docket No. 3232]

IN THE MATTER OF AMERICAN OPTICAL COMPANY ET AL.

SEC. 3.45 (e) (2) Discriminating in price—Indirect discrimination—Cumulative discounts.—Discriminating in price, in connection with distribution and sale of optical and ophthalmic products in commerce between the states and in District of Columbia, and on the part of respondent association and respondent corporation, their officers, etc., between different purchasers of such products of like grade and quality, by (a) granting or allowing, under respondents’ ‘big dealer’ (retailer) discount plan, cumulative or volume discounts on stock lenses, frames and mountings (items or types in greatest demand and making up bulk of purchases of respondents’ customers), on basis certain monthly or yearly aggregate purchases of all items included, whether themselves subject or not to such discounts, and irrespective of size or number of orders thus aggregated, and including among said items last referred to as not themselves subject to such discounts, prescription purchases and purchase of machinery and ophthalmological equipment; or by (b) continuing in effect, as described, respondents’ ‘big dealer’ (retailer) discount plan, differentials of which plan failed to make only due allowances for or to bear any consistent relation to differences, if any, in cost of sale or delivery of stock merchandise resulting from the differing quantities in which sale and delivery is made to different customers under said plan; with result that, while substantial number of respondents’ customers were able to secure discounts provided in their “big dealer” discount schedule, many other customers, engaged in competition with such “big dealers” in use and sale of respondents’ said products, did not receive benefit of such discounts, and with result that effect of such discrimination in price has been to injure and might be to injure, destroy or prevent competition with respondents’ retailer customers receiving benefit of such discrimination, and effect thereof was and might be substantially to lessen competition or tend to create a monopoly in the line of commerce in which respondents were engaged, or to injure, destroy or prevent competition with respondents in both the wholesale and manufacturing fields; prohibited. (Sec. 2 (a), 59 Stat. 2026; 16 U. S. C., Supp. IV, Sec. 13 (a))

CONTENTS

EXECUTIVE ORDER

Appointment of Frederick Morgan Davenport; designation as member and Chairman of Council of Personnel Administration

RULES, REGULATIONS, ORDERS

TITLE 16—COMMERCIAL PRACTICES:

FEDERAL TRADE COMMISSION:

Cease and desist orders: American Optical Co., et al. 693

Buoch & Lomb Optical Co., et al. 697

TITLE 17—COMMODITY AND SECURITIES EXCHANGE:

Securities and Exchange Commission:


TITe 26—INTERIOR Revenue:

‘s Bureau of Internal Revenue:

Income tax under the Revenue Act of 1938 (Regulations 101):

Chapter X—Corporations exempt from tax 700

Chapter XI—Corporations used to avoid surtax 704

Chapter XII—Tax on citizens and corporations of foreign countries; banks and trust companies; sale of oil or gas properties 705

Chapter XIII—Gain or loss; recognition, basis, determination 703

Chapter XIV—Depreciation and depletion 725

Chapter XV—Distributions by corporations; dividends 723

Chapter XVI—Additional exclusions from gross income 730

(Continued on next page)
TITLE 26—INTERNAL REVENUE

BUREAU OF INTERNAL REVENUE

[Regulations 101]

INCOME TAX UNDER THE REVENUE ACT OF 1938

(The Table of Contents and Chapters I–IX appeared in the Federal Register for Friday, February 10, 1939.)

CHAPTER X

Corporations Exempt From Tax

Subtitle C—Supplemental Provisions, Supplement A—Rates of Tax (Supplementary to Subtitle B, Part D)

Sec. 101. Exemptions from tax on corporations.—The following organizations shall be exempt from taxation under this title:

Art. 101-1. Proof of exemption.—A corporation is not exempt merely because it is organized and operated for profit. In order to establish its exemption and thus be relieved of the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption file an affidavit with the collector of the district in which it is located, showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and the disposition of such income, whether or not any of its income is credited to surplus or any income, or whether any of its income is credited to any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such affidavit should be attached copies of the charter or articles of incorporation, the by-laws of the organization, and the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the organization. The words "private shareholder or individual" in section 101 refer to individuals having a personal and private interest in the activities of the corporation. Although religious or apostolic associations or corporations exempt under section 101 are relieved from paying the tax, they are required to file returns of income (see article 101 (18)–1).

In the case of the particular classes of organizations listed below, the following additional information should be embodied in or attached to, and made a part of, the affidavit referred to above:

(1) Fraternal beneficiary societies, orders, or associations: (a) The number of subordinate lodges in active operation, (b) whether periodic meetings are actually held.

(2) Building and loan associations and cooperative banks: These associations and banks shall submit the information required by Questionnaire, Form 1027, copies of which may be obtained from any collector;

(3) Corporations, community chests, funds, or foundations claiming exemption under section 101 (6): To what extent the activities of the organization involve carrying on propaganda, or otherwise attempting, to influence legislation;

(4) Educational organizations: In addition to the information called for in (3) above, whether any of the shareholders are paid by the organization, and if so, the reason for such payment and the amount thereof;

(5) Hospitals: In addition to the information called for in (3) above, whether part-pay or non-pay patients are accepted and whether the amounts paid by part-pay patients are more than nominal;

(6) Business leagues: (a) A statement of the services performed for members, (b) a statement of the services performed for nonmembers;

(7) Clubs: The income received from the use of the facilities by the general public;

(8) Benevolent life insurance associations: (a) The number of counties in which the association accepts risks, (b) copies of the policies or certificates of membership;

(9) Mutual insurance companies: (a) Copies of the policies or certificates of membership; (b) if any substantial amount of income is claimed to be held for the payment of losses or expenses, a statement based upon a reliable table of loss experience demonstrating that the amount so held for the payment of losses is reasonably necessary; or in the case of expenses, a statement based upon reliable statistics showing that the expenses were incurred or that, in all probability, they will be incurred;

(10) Farmers' cooperative associations: These associations shall submit the information required by Questionnaire, Form 1028, copies of which may be obtained from any collector;

(11) Holy orders: (a) The name of the organization for which it holds title, (b) the information necessary to establish the exemption, under section 101, of the organization for which title is held.

The collector, upon receipt of the affidavit and other papers, will forward them to the Commissioner for decision as to whether the organization is exempt.

When an organization has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status unless it changes the character of its organization or operations or the purpose for which it was originally created. But see article 101 (18)–1 with respect to religious or apostolic associations or corporations. Collectors will keep a list of all exempt corporations, to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.

The exemption under section 101 referred to in this article and articles 101 (2)–1 to 101 (13)–1 from filing returns of income does not apply to returns of income (see sections 147 to 149).

[Sec. 101. Exemptions from tax on corporations.]

The following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

Art. 101 (1)–1. Labor, agricultural, and horticultural organizations.—The organizations contemplated by section 101 (1) as entitled to exemption from income taxation are those which—

(1) Have no net income inuring to the benefit of any member;

(2) Are educational or instructive in character; and

(3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations which have for their purpose, for example, the holding of periodic races, the profits from which inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

[Sec. 101. Exemptions from tax on corporations.]

The following organizations shall be exempt from taxation under this title—

(2) Mutual savings banks.—In order that a corporation may be entitled to exemption as a mutual savings bank, it must appear that it is an organization—

(1) Which has no capital stock represented by shares, and

(2) Whose earnings, less only the expenses of operation, are distributable wholly among the depositors.

If it appears that the organization has shareholders who participate in the profits, the organization will not be exempt.

A mutual savings bank need not be incorporated or be under public supervision, unless, in either case a State statute so requires, nor need it serve the public in general, in order to be exempt. It may confine its business to a designated class of individuals, such as employees of a single corporation, without losing its exempt status.

[Sec. 101. Exemptions from tax on corporations.]

[The following organizations shall be exempt from taxation under this title—]
(3) Fraternal benefit societies, orders, or associations, (A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

Art. 101 (3)-1. Fraternal benefit society.—A fraternal benefit society is exempt from tax only if operated under the “lodge system,” or for the exclusive benefit of the members of the society so operating. “Operating under the lodge system” means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

[Sec. 101. Exemptions from tax on corporations.]

[The following organizations shall be exempt from tax under this title—]

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members, and cooperatives substantially all the business of which is organized and operated for mutual purposes and without profit;

Art. 101 (4)-1. Building and loan associations and cooperative banks.—A building and loan association organized pursuant to and operating in accordance with the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax.

Cooperative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions such as those organized under the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax.

[Sec. 101. Exemptions from tax on corporations.]

[The following organizations shall be exempt from taxation under this title—]

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

Art. 101 (6)-1. Religious, charitable, scientific, literary, and educational organizations and community chests.—In order to be exempt under section 101 (6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals;

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the relief of indigent persons may receive voluntary contributions from persons intended to be relieved will not necessarily deprive it of exemption.

An educational organization within the meaning of the Act is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association with business or amusement features. An organization formed, or鸾ed of, to disseminate con-
prospective investors, to enable them to make sound investments, is not a business enterprise. Activities that further any common business interest, even though all of its income is devoted to the purpose stated. A stock exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of the law and is not exempt from tax.

[Sec. 101. Exemptions from tax on corporations.]

The following organizations shall be exempt from taxation under this title—

(6) Civic leagues or organizations not organized for profit but operated exclusively for purposes beneficial to the community as a whole, and, in general, include organizations engaged in promoting the welfare of mankind, other than organizations comprehended within section 101 (6). Certain local associations of employees are also expressly entitled to exemption under section 101 (8). The Act prescribes as conditions of exemption (1) that the membership of such an organization 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.

Ann. 101. (6)-1. Civic leagues and local associations of employees.—Civic leagues entitled to exemption under section 101 (8) comprise those not organized for profit but operated exclusively for purposes beneficial to the community as a whole, and, in general, include organizations engaged in promoting the welfare of mankind, other than organizations comprehended within section 101 (6). Certain local associations of employees are also expressly entitled to exemption under section 101 (8). The Act prescribes as conditions of exemption (1) that the membership of such an organization 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.

Ann. 101 (6)-1. Social clubs. —The exemption granted by section 101 (9) applies to practically all social and recreational clubs which are supported by membership fees, dues, and assessments. If a club engages in traffic, in agriculture, or in the sale of real estate, timber, etc., for profit, such club is not exempt and operates not exclusively for the purpose of pleasure, recreation, or social purposes. Generally, an incidental sale of property will not deprive the club of the exemption.

[Sec. 101. Exemptions from tax on corporations.]

The following organizations shall be exempt from taxation under this title—

(10) Fire insurance associations of a purely local character, mutual hail, cyclone, casualty, or fire insurance companies or associations. —To be exempt under section 101 (11) the business of the organization must be purely mutual and its income must be used or held for the purpose of paying losses or expenses.

Ann. 101 (11)-1. Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations. —To be exempt under section 101 (11) the business of the organization must be purely mutual and its income must be used or held solely for the purpose of paying losses or expenses. Neither the extent of the territory in which the company may properly operate nor the fact that it accepts premium deposits instead of assessments is decisive as to its exemption. The writing of nonmutual insurance regardless of amount will deprive a company of the exemption.

The term “casualty” as used in section 101 (11) is limited to those forms of indemnity insurance providing for payment of loss or expense because of accident, resulting in bodily injury to, or death of, the insured.

[Sec. 101. Exemptions from tax on corporations.]

The following organizations shall be exempt from taxation under this title—

(a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live-stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses on the 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 a non-discriminatory basis, the association does not meet the requirements of the Act and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned, and if, in fact, if products are marketed for nonmember producers, the proceeds of the sale, 

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less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such persons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Act that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Act does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Act patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, provides 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 who 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, live stock raisers, dairy farmers, and truck gardeners, 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 the association in the operation and maintenance of a farmer or farmer’s household. The provisions of (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for that 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 by the association is not produced. The provisions of (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph.

(c) In order to be exempt under either (a) or (b) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in (a). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if it maintains no net income for its own account other than that reflected in a reserve or surplus authorized in (a). The provisions of (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph.

(d) Cooperative associations engaged in operations distinguished from those of farmers, fruit growers, and the like, such as marketing building materials, are not exempt.
corporations engage in business for the common benefit of their members; but any surplus therefrom (including any reserve, retained earnings, or undistributed profits thereof) which has been distributed or not, of the net income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Art. 101 (18).—Religious or apostolic associations or corporations.—Religious or apostolic associations or corporations are exempt from taxation under Title I if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101 (18) and this article shall make for each taxable year a return stating specifically the items of its gross income and deductions, and its net income, and there shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the net income of the association or corporation for such year. If the taxable year of any member is different from the taxable year of the association or corporation, the distributive share of the net income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the net income of the association or corporation for the taxable year of the association or corporation ending within the taxable year of the member.

CHAPTER XI
Corporations Used to Avoid Surtax

Sec. 102. Surtax on corporations improperly accumulating surplus.—(a) Imposition of tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in Title IA or a foreign personal holding company as defined in Supplement P) if such corporation is formed or availed of for the purpose of preventing the imposition of the surtax upon the shareholders, the individual surtax upon a corporation or a chain of corporations, or (2) nonresident alien Individuals who, by their application of section 211 (a) as amended, would not be subject to surtax with respect to distributions of the corporation if made.

For the computation of the surtax see article 102-4.

Art. 102-1. 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 can be determined by circumstances other than the evidence specified in the Act, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the purpose of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in Title IA, and foreign personal holding companies, as defined in Supplement P, are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax, the shareholders in the M Corporation who are subject to the individual surtax may be subject to the corporate surtax as to the distributive share of the surtax imposed on the N Corporation to its individual shareholders, notwithstanding 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, foreign or domestic, 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 which if made would constitute income from sources within the United States (see section 119) or (2) foreign corporations if any beneficial interest therein is owned directly or indirectly by any person 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.

For the computation of the surtax see article 102-4.
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 of the corporation, if the existence of such a purpose is determinable 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 to avoid surtax upon shareholders, and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation, if the existence of such a purpose is determinable to avoid surtax upon shareholders, while if earnings or profits of a corporation may be accumulated for the purpose of avoiding 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 formal business of the first corporation. Earnings or profits of one corporation put into the second, that is, either invested in stock or in anything else, may, therefore, if a subsidiary relationship is established, constitute employment of the income of its own business. Investment by a corporation of its income in stocks 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 enough to show that the corporation owns 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 number of shares held and the 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 104.)

Ann. 102-4. Unreasonable accumulations of profits.—An accumulation of earnings or profits including the undistributed earnings or profits of prior years is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the earnings or profits are accumulated under the circumstances set forth in the definition 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 earnings are properly accumulated if retained for the purposes of 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 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 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 in 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 formal business of the first corporation. Earnings or profits of the first corporation put into the second, that is, either invested in stock or in anything else, may, therefore, if a subsidiary relationship is established, constitute employment of the income of its own business. Investment by a corporation of its income in stocks 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 enough to show that the corporation owns 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 number of shares held and the 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 104.)

Ann. 102-4. Computation of undistributed section 102 net income.—In computing the tax basis for corporations subject to the provisions of section 102, the "section 102 net income" is first computed. This is accomplished in the case of a domestic corporation by subtracting from the corporate net income, as defined in sections 21 and 204, (a) Federal income, war-profits, and excess-profits taxes paid 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 of gifts, payment of taxes, or fines or penalties paid within the taxable year; and (c) deductions from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (c). 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 (gross income from sources without 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, the amount of income or loss derived from sources within the United States or any political subdivision thereof or of the District of Columbia or of the possession 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 27 (a), relating to interest on certain obligations of the United States and Government corporations.

CHAPTER XIII

Tax on Citizens and Corporations of Foreign Countries—Banks and Trust Companies—Sale of Oil or Gas Properties

Ann. 103. Dates of tax on citizens and corporations of certain foreign countries.—Whenever the provisions of the income tax laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial
taxes, the President shall so proclaim and the rates of tax imposed by sections 11, 12, 13, 14, 201 (b), 204 (a), 207, 211 (a), 251 (a), and 262 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each corporation organized or charted under the laws of any foreign country; but the tax at such doubled rate shall be considered as imposed by section 11, 12, 13, 14, 201 (b), 204 (a), 251 (a), or 262, 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 attributable to such sale, and if the President finds that the laws of any foreign country with respect to the exercise of fiduciary powers similar to those of the business of which consists of receiving and locating claims, or by exploring or discovering undeveloped claims, has permitted to national banks under section 106, the surtax imposed on such property or interest therein, less the deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise apportioned) rata- tely to the gross income from all sources. The 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 re- turn a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or ap- portioned.

Sec. 106. Surtax on certain amounts received from the United States.—(a) Computation of amount realized.—The method of computation provided for in section 105, 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 the acquisition of property. The surtax limitation provided in section 106 is not applicable to any amount received from the United States which constitutes an interest therein which was included in the claim or in any judgment thereon or has accrued on such judgment.

CHAPTER XIII

Gain or Loss—Recognition, Basis, Determination

Supplement B—Computation of Net Income (Supplementary to Subtitle B, Part I)

Sec. 111. Determination of amount of, and recognition of, gain or loss.—(a) Computation of gain or loss.—The gain from the sale of any property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (a). The cost or other basis provided in 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 re- mainders 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 to be considered.

Even though property is not sold or otherwise disposed of, gain (inclusive 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 ad- justed basis of the property. Until some identifiable event fixes the actual sus- taining of a loss and the amount thereof the Act takes no account of it. The provisions of this paragraph may be illustrated by the following example:

Example: A purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1936, A's ad- justed basis for the stock had been reduced to $5,000 by losses and distributions described in section 113 (b) (1) (A) and (D). He received
In 1938 a further distribution of $5,000, being a distribution described in section 112 (b) (1). This distribution applied against the adjusted basis as required by section 112 (b) (1) (D) except that basis by $4,000. The amount of the excess, namely, $4,000, is a gain realized by A in 1938 includible as a gain from the stock, in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 112 (b). If A sells the stock in 1939 for $5,000, he realizes in 1939 a gain of $5,000, since the adjusted basis of the stock for the purposes 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.—(c) General rule for exchanges of property.—In general, the entire amount of the gain or loss is to be recognized. See section 112 (d) (1) and (7) with respect to nonrecognition of gain or loss upon the receipt of property distributed in complete liquidation of a corporation under certain specifically described circumstances. See sections 112 (b) (3) and 377 with respect to nonrecognition of gain or loss upon exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.

Art. 112 (a) 1. Sales or exchanges.—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Act provides that such differences shall not be deemed controlling, and that gain or loss shall not result at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

The Act makes specific provision for the case in which, in addition to property which may be received tax free on the exchange, there is received as boot other property or money. In such a case gain is recognized only 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, are stated and understood by application of the rule, strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Act only if the exchanges, and in the same manner, the specific description in the Act of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only. See section 112 (d) (1) and (7) with respect to nonrecognition of gain or loss upon the receipt of property distributed in complete liquidation of a corporation under certain specifically described circumstances. See sections 112 (b) (3) and 377 with respect to nonrecognition of gain or loss upon exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.

[Sec. 112. Recognition of gain or loss.]
(b) Exchanges solely in kind.—(1) Property held for productive use or investment.—(2) Any gain or loss shall be recognized if property held for productive use in trade or business or for investment is exchanged for other property or money. In such a case, the gain or loss shall be recognized to the extent of the gain or loss upon exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.

Art. 112 (b) 1. Property held for productive use in trade or business or for investment.—As used in section 112 (b) (2), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. Under this definition, property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increase in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges a stock 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 farm truck or a passenger automobile for a new passenger automobile of like kind and for the same use; 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 20 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind. Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1949, for Treasury bonds maturing June 15, 1953, or (2) a home mortgage bond for bonds of the Home Owners' Loan Corporation.

[Sec. 112. Recognition of gain or loss.]
(b) Exchanges solely in kind.—(3) Stock for stock of the same corporation.—The gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation. No gain or loss is recognized if preferred stock is exchanged for preferred stock in the same corporation.

Art. 112 (b) 2. 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 section 112 (b) (2) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation.

[Sec. 112. Recognition of gain or loss.]
(b) Exchanges solely in kind.—(3) Stock for stock on reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same.—Gain or loss on reorganization.—No gain or loss shall be recognized if a corporation a party to a reorganization is exchanged solely for stock or securities in such corporation or 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 in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Art. 112 (b) 3. Transfer to corporation controlled by transferor.—As used in section 112 (b) (5), "corporation controlled by transferor" includes individuals, trusts or estates, partnerships and corporations (see section 501); and to be in "control" of the transferor corporation such person or persons must own immediately after the transfer stock possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote and at least 20 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 ex-
change" does not include 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 expedi-
tion and orderly proceeding.

Example 1: A owns certain real estate which cost him $50,000 in 1929, but which has a fair market value of $150,000 in 1938. He transfers this property to the M Corporation, a newly formed company, for all the latter's capital stock. No gain or loss is recog-
nized on the transaction.

Example 2: C owns a patent right worth $25,000 and D owns a manufac-
turing plant, worth $75,000. C and D organize the R Corporation with an au-
torized capital stock of $100,000. C transfers his patent right to the R Cor-
poration for $25,000 of its stock and D transfers his plant to the new cor-
poration for $75,000 of its stock. No gain or loss to C or D is recognized.

Example 3: B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,-
000 in 1938. He transfers the property to the N Corporation in 1938 for 78 per-
cent of each class of stock of the cor-
poration, 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 tax-
able gain of $150,000 on this transaction. (See section 112 (h).)

Arr. 112 (b) (5) - 2. Records to be kept and information to be filed.—Every per-
son 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 tax-
able period in which the exchange takes place a consistent statement of all facts pertinent to the recognition or nonrecognition of gain or loss upon such exchange, including—

1. A description of the property transferred, or of his interest in such prop-
erty, together with a statement of the cost or other basis thereof, adjusted to the date of the transfer, and

2. A statement of the amount of stock or securities and other property or money which passed to the transference and 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 corpora-
tion immediately after the exchange (showing as at each class the number of shares owned and the voting power of each share).

Permanent records in substantial form shall be kept by every taxpayer who par-
ticipates in a tax-free exchange under section 112 (b) (5) showing the cost or other basis in his hands of the transferred property or stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a sub-
sequent disposition of such stock or securities and other property received in the exchange.

(Sec. 112, Recognition of gain or loss.)

(b) (5) Property received by corporation on complete liquidation of another.—(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 property is specified in such resolution; or

(B) no distribution of the property occurs within the taxable year; or

(C) the corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, and has continued to be at all times until the property is specified in such resolution; or

(D) such corporation is one of a series of distributions by a corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which 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) at all times until the receipt of the property, has at all times until the receipt of the property, been the actual owner of stock (in such other corpo-
rations which have a fair market value of $200,-
000 in 1938. He transfers this property to the corporation in accordance with a plan of liqui-
dation, and has continued to be at all times until the receipt of the property, in complete cancellation or redemption under the plan, as described in paragraph (5) of this subsection, of the shares held by the taxpayer.

Arr. 112 (b) (6) - 1. Distributions in liquidation of subsidiary corporation.—

(a) General.—Under the general rule prescribed by section 115 (a) 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 (a). Section 112 (b) (6) excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distri-
bution in complete liquidation of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirement. Section 112 (i) places a limitation on the application of section 112 (b) (6) in the case of foreign corporations. See article 113 (a) (5) - 1 for the rules for deter-
miming gain or loss from the subsequent sale of property received upon complete liquidations such as described in this article.

(b) Requirements for nonrecognition of gain or loss.—The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in any liqui-
dating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). The Act expressly requires that the recipient corporation must have
been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. The Act also expressly requires that the recipient corporation shall at no time on or after the date of 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 liquidating corporation beginning after December 31, 1935.

To constitute a distribution in complete liquidation within the meaning of section 112 (b) (6), the distribution must be (a) made by the liquidating corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation or (b) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. It is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts and liquidating the assets and distributing the remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). (See article 22 (a)–21.)

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (6), it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Act and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 112 (b) (6), even though for purposes of those provisions in section 112 the stock is not received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or receivables in a tax-free exchange as described in section 112 (b) (4) and the cancellation or redemption of such stock owned by the recipient corporation is treated as occurring as a result of a tax-free exchange described in section 112 (b) (3). The application of this paragraph may be illustrated by the following example:

Example: On July 1, 1938, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and declared on July 1, 1938, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of the common stock of the M Corporation. By a statutory merger consummated on August 1, 1938, pursuant to a plan of liquidation adopted on July 1, 1938, the M Corporation was merged into the O Corporation, the O Corporation under the plan issued 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.

Annual (b) (6)–2. Liquidations completed within one taxable year.—If in a liquidation completed within one taxable year, pursuant to a plan of complete liquidation, distributions in complete liquidation are received by a corporation which owns the specified amount of stock in the liquidating corporation and which continues qualified with respect to the ownership of such stock within such year is completed (see article 112 (b) (6)–1), then no gain or loss shall be recognized with respect to the distributions received by the recipient corporation. In such case no waiver or bond is required of the liquidating corporation under section 112 (b) (6).

Annual (b) (6)–3. Liquidations covering more than one taxable year.—If the plan of liquidation is consummated by a series of distributions covering a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall in addition to the requirements of article 112 (b) (6)–1, be subject to the following requirements:

(a) In order for the distribution in liquidation to be brought within the exception provided in section 112 (b) (6) to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred to the recipient 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 filling 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 for 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 in the amount 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 202 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, none of the Revenue Act of 1926, as amended (paragraph 35 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may
be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal (d) and (e) of this article and article 112 (b) (6) or if the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 113 (a) (15). (See article 113 (a) (15)–1.) However, if the transfer of the property is not completed within the 3-year period allowed by section 112 (b) (6) or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 112 (b) (6) or section 113 (a) (15) and the amount of any additional tax due upon such recomputation shall be promptly paid.

Anz. 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.

Anz. 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 113 (b) (6) showing the information required by this article to be submitted with its return. The plan of liquidation shall be adopted by each of the corporations specified, 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 taxable 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 any other documents showing in detail all transactions incidental to, or pursuant to, the plan.

(2) A list of all the properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement as to its ownership of all classes of stock of the liquidating corporation (showing as to each class the number of shares and percentage of all classes of stock of the liquidating corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) which has been issued by the liquidating corporation or by the shareholder as the result of the adoption of such plan of liquidation.

(4) The basis of the gain or loss, if any, recognized by the recipient corporation for each of the taxable years in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one taxable year, for each taxable year in which a distribution is received under the plan, the tax liability for each of the taxable years in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one taxable year, for each taxable year in which a distribution is received under the plan, the tax liability for each of the taxable years in which the liquidation occurs.

(5) Noncorporate shareholders.—In the case of a qualified electing shareholder other than a corporation—

(I) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation at the time of the adoption of the plan of liquidation (whether or not such earnings and profits are in fact distributed during the month of December, 1938), but without diminution by reason of distributions made during the month of December, 1938.

(II) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remaining gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

(F) Corporate shareholders.—In the case of a corporation the gain shall be recognized only to the extent of the greater of the following:

(I) The portion of the assets received by it which consists of money, or of stock or securities acquired by the liquidating corporation after April 9, 1938; or

(II) Its ratable share of the earnings and profits of the liquidating corporation accruing after February 28, 1938, but without diminution by reason of distributions made during the month of December, 1938.

Anz. 112 (b) (7)–1. Corporate liquidations in December, 1938.—(a) General.—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders who in a corporation the gain shall be recognized on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in liquidation. Only qualified electing shareholders are each entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)–2. For the basis of...
property received on such liquidations, see section 113 (a) (18).

(b) Type of liquidation.—The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. Such plan may be adopted at any time after May 28, 1938, and before the first distribution under the liquidation occurs, even though the date of adoption falls in a taxable year of the liquidating corporation to which the Revenue Act of 1938 applies. The Act specifically requires that the distribution be in complete cancellation or redemption of all the stock, and the Act also requires that the transfer of all the property, both tangible and intangible, of the corporation under the liquidation occur entirely within the month of December, 1938, but if proper arrangements are made in good faith for the payment, after December 31, 1938, of unascertained or contingent liabilities and expenses, this requirement will be considered to have been complied with. The assets reserved for this purpose must be in cash and must be reasonably in amount, not to exceed such assets that the corporation dissolve in December, 1938, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

Ann. 112 (b) (7)—5. Qualified electing shareholder.—A person who is (a) a shareholder of the liquidating corporation, and (b) a qualified electing shareholder if at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, it is the owner of stock of the liquidating corporation possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote upon the adoption of the plan of liquidation. All other shareholders are divided into two groups for the purposes of determining whether or not the stock he owns is entitled to vote on the adoption of the plan of liquidation) is a qualified electing shareholder if—

1. His written election to be governed by the provisions of section 112 (b) (7) (which cannot be withdrawn or revoked) with the instructions printed thereon has been made and filed as prescribed in article 112 (b) (7)—3; and
2. Like elections have been made and filed by owners of stock possessing at least 50 percent of the total combined voting power of all classes of stock owned by shareholders of the same group on the date of, and entitled to vote upon, the adoption of the plan of liquidation, whether or not the shareholders making such elections actually realize gain upon the cancellation or redemption of such stock upon the liquidation.

Example: The R Corporation has outstanding 20 shares of common stock on July 1, 1938, the date of the adoption of a plan of liquidation within the provisions of section 112 (b) (7), each entitled to one vote upon the adoption of such plan of liquidation. Ten of such shares are owned by the S Corporation, two each by the X Corporation and the Y Corporation, one by the Z Corporation, and one each by A, B, C, D, and E, individuals. There are also outstanding two shares of preferred stock, not entitled to vote on liquidation, one share being owned by F, an individual, and one share by the P Corporation. The S Corporation, being a corporate shareholder and the owner of 50 percent of the voting stock, may make an election to be a qualified electing shareholder under any circumstances. In order for any other corporate shareholder to be a qualified electing shareholder, it is necessary that the X Corporation and the Y Corporation file their written elections to be governed by section 112 (b) (7). If this is done, the P Corporation will also be a qualified electing shareholder if it has filed a like election. Similarly, in the case of the individual shareholders, some combination of four of the individual holders of the common stock must have filed their written elections, before any individual shareholder may be considered a qualified electing shareholder, but if this is done, F will also be a qualified electing shareholder if he has filed a like election.

An election to be governed by the provisions of section 112 (b) (7) relates to the treatment of gain realized upon the cancellation or redemption of stock upon liquidation and can therefore be made only by or on behalf of the person by whom gains, if any, will be realized. Thus, the shareholder who may make such election must be the actual owner of the stock and not a mere record holder, such as a nominee. A shareholder is entitled to make an election relative to the gain only on stock owned by him at the time of the adoption of the plan of liquidation. The election is personal to the shareholder making it and does not follow such stock into the hands of a transferee.

Ann. 112 (b) (7)—3. Making and filing of written elections.—An election to be governed by section 112 (b) (7) shall be made in duplicate under oath or affirmation on Form 964 in accordance with the instructions thereon and with these regulations. Such duplicate originals shall be filed by the shareholder or by the liquidating corporation with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, within 30 days after the adoption of the plan of liquidation. A copy shall also be attached to and made a part of the shareholder's income tax return for his taxable year in which the transfer of all the property under the liquidation occurs.

Ann. 112 (b) (7)—4. Treatment of gain.—(a) Computation of gain.—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 110 (e), and gain from the receipt of such amounts is determined as provided in section 111. Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation. The limited recognition and special treatment accorded by section 112 (b) (7) applies only to the gain on such shares of stock upon which gain was realized and not to net gain computed by setting off losses realized on some shares against gain on others.

(b) Recognition of gain.—Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

1. Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of December 31, 1938, without diminution by reason of distributions made during the month of December, 1938; or
2. Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by such shareholder after April 9, 1938, and before April 9, 1938, or the mere replacement after April 9, 1938, of lost or destroyed certificates or instruments acquired on or before April 9, 1938, or the mere conversion of certificates or instruments into certificates or instruments of larger or smaller denominations will not constitute an acquisition within the meaning of the phrase "acquired after April 9, 1938." Nor will such an acquisition result from the issuance after April 9, 1938, of certificates of stock in connection with a subscription made and accepted on or before April 9, 1938.

(c) Treatment of recognized gain.—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section

No. 28—3
112 (b) (7) (E) (1) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized and taxed to him as a long-term capital gain, or as the case may be, in the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized and treated as a capital gain.

Example: The X Corporation has only one class of stock outstanding, owned in equal amounts by three shareholders. The basis of the stock owned by each shareholder is $50, each having bought his stock in a single bloc prior to the date of the adoption of a plan of liquidation conforming to the requirements of section 112 (b) (7). One of such shareholders is an individual and two are corporations and all are qualified electing shareholders. The X Corporation has earnings and profits accumulated after February 28, 1913, of $60, its assets consisting of property (other than stock or securities) acquired after February 28, 1913, and money with a fair market value of $240, cash of $75, and stock and securities acquired after April 9, 1938, with a fair market value of $90, all of which assets are distributed in December, 1938, to the shareholders pro rata in complete liquidation of the corporation as provided in section 112 (b) (7). Each shareholder, therefore, receives, in cash and property, $135 and his gain is $85.

In the case of each shareholder $55 of this gain is recognized, since such amount represents the sum of the cash received by him and the fair market value of the stock and securities received by him which were acquired by the X Corporation after April 9, 1938, and is greater than his ratable share of the earnings and profits ($20). In the case of the corporate shareholders this amount is treated as a long-term capital gain. In the case of the individual shareholder, however, $20, being the amount of the shareholder's ratable share of the earnings and profits, is taxable to him as a dividend, and $35, being the difference between the shareholder's ratable share of the earnings and profits and the sum of the cash and stock and securities received by him, is recognized and treated as a short-term or long-term capital gain, as the case may be. The remainder of each shareholder's stock had been long-term capital gain, as the case may be. In the case of the corporation, the entire amount of the gain which is recognized and treated as a long-term capital gain, or as the case may be, in the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized and treated as a capital gain.

Example: A, who is not a dealer in real estate, in 1938 exchanges real estate, which he purchased (for investment) in 1921 for $5,000, for corporate real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and he receives in addition $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

See article 113 (a) (6)–1 for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this article.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see article 112 (g)–4.

ANR 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)).

ANR 112 (e)–1. Nonrecognition of loss.—The Act provides that in no event shall a loss be recognized from a tax-free exchange of property under section 112

112 (b) (7) (E) (1) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized and taxed to him as a long-term capital gain, or as the case may be, in the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized and treated as a capital gain.

Example: The X Corporation has only one class of stock outstanding, owned in equal amounts by three shareholders. The basis of the stock owned by each shareholder is $50, each having bought his stock in a single bloc prior to the date of the adoption of a plan of liquidation conforming to the requirements of section 112 (b) (7). One of such shareholders is an individual and two are corporations and all are qualified electing shareholders. The X Corporation has earnings and profits accumulated after February 28, 1913, of $60, its assets consisting of property (other than stock or securities) acquired after February 28, 1913, and money with a fair market value of $240, cash of $75, and stock and securities acquired after April 9, 1938, with a fair market value of $90, all of which assets are distributed in December, 1938, to the shareholders pro rata in complete liquidation of the corporation as provided in section 112 (b) (7). Each shareholder, therefore, receives, in cash and property, $135 and his gain is $85.

In the case of each shareholder $55 of this gain is recognized, since such amount represents the sum of the cash received by him and the fair market value of the stock and securities received by him which were acquired by the X Corporation after April 9, 1938, and is greater than his ratable share of the earnings and profits ($20). In the case of the corporate shareholders this amount is treated as a long-term capital gain. In the case of the individual shareholder, however, $20, being the amount of the shareholder's ratable share of the earnings and profits, is taxable to him as a dividend, and $35, being the difference between the shareholder's ratable share of the earnings and profits and the sum of the cash and stock and securities received by him, is recognized and treated as a short-term or long-term capital gain, as the case may be. The remainder of each shareholder's stock had been long-term capital gain, as the case may be. In the case of the corporation, the entire amount of the gain which is recognized and treated as a long-term capital gain, or as the case may be, in the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized and treated as a capital gain.

Example: A, who is not a dealer in real estate, in 1938 exchanges real estate, which he purchased (for investment) in 1921 for $5,000, for corporate real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and he receives in addition $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

See article 113 (a) (6)–1 for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this article.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see article 112 (g)–4.

ANR 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)).

ANR 112 (e)–1. Nonrecognition of loss.—The Act provides that in no event shall a loss be recognized from a tax-free exchange of property under section 112...
(b) To (g), 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, the Commissioner may take the basis of the property received in such an exchange for the purpose of determining gain or loss from the subsequent sale thereof, see article 112 (a) (6) - I.

As to the nonrecognition of loss upon the receipt of property by one corporation in complete liquidation of another corporation under certain specifically described circumstances, see section 112 (b) (6).

[Sec. 112. Recognition of gain or loss.]

(f) Involuntary conversions.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the acquisition of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

Art. 112 (f).—1. Reinvestment of proceeds of involuntary conversion.—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be availed of by a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens and mortgages against the property and itself pays the same, the amount so retained should be included in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

The provisions of section 112 (f) are applicable to property used for residential or farm purposes.

The proceeds of a use and occupancy insurance policy, which by its terms insured against actual contract loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

There is no investment in property similar in character and devoted to a similar use if—

(1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(3) The owner of a requisitioned tug uses the proceeds to buy barges.

(d) An award for property taken for street widening is applied toward payment of special assessments for benefits accruing to the remaining property.

It is incumbent upon a taxpayer in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another to cite all the facts relating to the transfer or acquisition of stock and securities of the old corporation and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

Art. 112 (g).—1. Purpose and scope of exception of reorganization exchanges.—Purpose: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property acquired is not material to the continued existence of the business enterprise conducted by a person who was the owner of the old property. The purpose of the reorganization provisions of the Act is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Act, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Act are a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Act recognizes as a reorganization the exchange (made by a person who was the owner of a business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Act recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is no 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 gen-
eral rule. Accordingly, under the Act, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

Scope: The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112 (b) (3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112 (b) (4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112 (g) limits the definition of the term "party to a reorganization." From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 112 (g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in subsections (a) and (d) of section 112. Under section 112 (a) a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

The provisions of the Act referred to in the preceding paragraph of this article are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

Axt. 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 the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

The words "statutory merger or consolidation" refer to a merger or consolidation effected in pursuance of the corporate laws of the United States or of a State or Territory or the District of Columbia.

In order to qualify as a "reorganization" under section 112 (g) (1) (B), the acquisition by the acquiring corporation of the required amount of the stock, or of substantially all the properties, of the other corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation. If, for example Corporation X exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of the required amount of stock, or of the properties, of Corporation Y, the transaction is not a "reorganization" under section 112 (g) (1) (B). A "recapitalization," and therefore a reorganization, takes place if, for example,

1. A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;
2. There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;
3. A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or
4. An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

The term "a party to a reorganization" includes, in addition to a corporation which performs the specific act constituting the reorganization as described and defined in section 112 (g) (1), only a corporation specified in section 112 (g) (2). Both corporations are parties to the reorganization if under statutory authority Corporation A is merged into Corporation B; and all three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporations C and D are consolidated into Corporation E. Both corporations are parties to the reorganization if it consists of the transfer by Corporations F and G of part of the assets of Corporation F in exchange for all of the capital stock of Corporation G. Only Corporations H and J are parties to the reorganization if it consists of the transfer by Corporations F and G of part of the assets of Corporation F in exchange solely for all or a part of its voting stock of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of the stock of Corporation G, or substantially all of the properties of Corporation G.

4. The transfer by Corporation H of all or a part of its voting stock to Corporation K, if immediately after the transaction Corporation H or its stockholders, or both, are in control of Corporation K ("control" for the purpose of this transaction being defined in section 112 (h) as the...
Corporation in exchange for the issuance of 1938 February profits of the exchange of property, the remainder of the distributees ratable share of the dividend, such an amount of the gain recognized to each distributee in section 112 of a taxable dividend, then, as provided would not be recognized.

The exchange of stock or securities solely for stock or securities of the same corporation in the case of (a) a re-capitalization of a corporation, or (b) a mere change in the identity, form, or place of organization of a corporation, however effected.

Art. 112 (g)–4. Exchanges in reorganization for stock or securities and other property or money.—If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example: A, in connection with a reorganization, in 1938, exchanges a share of stock in the X Corporation purchased in 1928 at a cost of $100 for a share of stock of the Y Corporation (a party to the reorganization), which has a fair market value of $90, plus $20 in cash. The gain from the transaction is $10 and is recognized and taxed as a gain from the exchange of property. But see section 117. However, if the share of stock received had a fair market value of $70, the loss from the transaction of $30 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, and (1) in exchange for the issuance of all of the stock of the Y Corporation and the payment of $50,000 in cash to the stockholders of the X Corporation, A, who owns one share of stock in the X Corporation, for which he in 1928 paid $100, receives a share of stock in the Y Corporation and the sum of $50 in cash in addition. A gain of $50 is recognized to A.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to the reorganization, for stock or securities in another corporation a party to the reorganization and other property or money, then, as provided in section 112 (d) (1), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized, under the provisions of section 112 (d) (2), in an amount not in excess of the sum of the money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 112 (e)).

Art. 112 (g)–5. Receipt of stock or securities in reorganization without surrender of stock or securities in reorganization.—Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, 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 (b)) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (1) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (2) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings or profits shall be apportioned and used to reduce the basis provided in section 113 of the stock in respect of which the distribution was made; and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. (See article 111–1.)

Art. 112 (g)–6. Records to be kept and information to be filed with returns.—(a) The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of duly constituted responsible officers, and appear upon the official records of the corporation. Each corporation a party to a reorganization shall file as a part of its return for its taxable year within which the reorganization occurred a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the reorganization, including

1. A certified copy of the plan of reorganization, together with a statement under oath showing in full the purposes thereof and in detail all transactions incident to, or pursuant to, the plan.

2. A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan.

3. A statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(b) Every taxpayer, other than a corporation a party to the reorganization, who receives stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization shall incorporate in his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

1. A statement of the cost or other basis of the stock or securities transferred in the exchange, and

2. A statement in full of the amount of stock or securities and other property or money received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

[Sac. 112. Recognition of gain or loss.]

(b) Definitions of certain terms. In this section the term "control" means the ownership of stock or securities of at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Art. 112 (h)–1. Control of corporation.—Section 112 (h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112 (h) (2) and section 113 (g) (1). It is provided specifically that this
definition is limited to the meaning of the term "control" as that term is used in section 112.

[Sec. 112. Recognition of gain or loss.]

(i) Foreign corporations.—In determining the extent to which gain shall be recognized in the case of any of the exchanges described in subsection (b) (2), (4), (3), or (6), or described in subsection (d), a foreign corporation shall 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.

Ann. 112 (i)–1. Reorganization with, or transfer of property to, a foreign corporation. —A foreign corporation will not be considered a corporation to which a tax-free transfer of property for stock or securities may be made, or a corporation a party to a reorganization with which a tax-free reorganization exchange may be made, or a corporation a party to a tax-free liquidation distribution may be made, unless, prior to the transfer, exchange, or liquidation, it has been established to the satisfaction of the Commissioner that such transfer, exchange, or liquidation, is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The term "Federal Income taxes" includes the excess-profits tax on the net income of a corporation referred to in section 106 of the Revenue Act of 1935, section 71 of the Revenue Act of 1936, and section 602 of the Revenue Act of 1938.

Whether any of the exchanges or distributions referred to in section 112 (i), involving a foreign corporation, is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, is a question to be determined from the facts and circumstances of each particular case. In any such case if a taxpayer desires to establish that the exchange or distribution is not in pursuance of such a plan as aforesaid 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 in the case of such exchange or distribution. If the reorganization or the transfer is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

[Sec. 112. Recognition of gain or loss.]

(j) Installment obligations.—For nonrecognition of gain or loss in the case of the installment obligations, see section 44 (d).

Sec. 113. Adjusted basis for determining gain or loss. —The basis of property shall be the cost of such property; except that—

Art. 113 (a)–1. Scope of basis for determining gain or loss.—The basis of property for the purpose of determining gain or loss shall not be the adjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this article and articles 113 (a)–2 to 113 (a)–18 (–1), inclusive, has reference to the unadjusted basis.

Art. 113 (a)–2. General rule. —In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in paragraphs (1) to (10) of section 113 (a).

[Sec. 113. Adjusted basis for determining gain or loss.]

[a] Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(1) Inventory value. —If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

Art. 113 (a) (1)–1. Property included in inventory.—The last inventory value of property which should be included in inventory is the basis of such property. The requirements with respect to the valuation of an inventory are stated in articles 22 (c)–1 to 22 (d)–4, inclusive.

[Sec. 113. Adjusted basis for determining gain or loss.]

[a] Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(2) Gifts after December 31, 1929.—If the property was acquired by gift after December 31, 1929, the basis shall be the same as it would be in the hands of the donee or the last preceding owner by whom it was not acquired by gift. For the purpose of determining the loss, the basis is as so determined, or the fair market value of the property at the time of the gift, whichever is lower. All titles to property acquired by gift relate back to the time of the gift, even though the interest of him who takes the title was, at the time of the gift, legal, equitable, vested, contingent, conditional, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. 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In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a descendent of the property, or was acquired by gift, whether subject at any time to any restrictions or debts, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person be the trustee under the gift instrument, the beneficiary, or any other person to whom such uniform basis is applicable, and whether the title is a
under the instrument of gift, and the
reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in
lieu of the basis specified in paragraph
(b).
(c) 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 deter-
mine the cost of the property and, if
pertinent, its fair market value as of
March 1, 1913.
[Sect. 113. Adjusted basis for deter-
ing gain or loss.]
(a) Basis (unadjusted) of property.—
The basis of property shall be the cost
of such property; except that—
(3) Transfer in trust after December
31, 1920.—If the property was acquired
after December 31, 1920, by a transfer in trust
(other than by a transfer in trust by a
bequest or devise) the basis shall be the same
as it would be in the hands of the grantor;
increased in the amount of gain or decreased
in the amount of loss recognized to the
grantor under such trust and which would
be applicable to the year in which the
transfer was made.
Ann. 113 (a) (3). Transfer in trust
after December 31, 1920.—(a) Property
transferred in trust after December
31, 1920, by a transfer in trust.
(b) Basis.—The basis of property
so acquired is the same as it would be in the
hands of the grantor, and the rein-
vestment of the trust and distribution of the
property of the decedent is the fair market value
at the time of such acquisition.
Ann. 113 (a) (4). Gift or transfer in
trust prior to January 1, 1921.—(a) Gift
or transfer in trust on or before December
31, 1920, the basis shall be the cost of
such property at the time of such acquisition.
Ann. 113 (a) (4). 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 devisee or bequestee; or by an instru-
ment which, under section 113 (a) (5),
shall be treated as though it were a will.
(b) Basis.—The basis is the fair mar-
tet 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 (a) of article 113 (a) (2),
or by equivalent methods.
[Sect. 113. Adjusted basis for deter-
ing gain or loss.]
(a) Basis (unadjusted) of property.—
The basis of property shall be the cost
of such property; except that—
(5) Property transmitted at death.—If
the property was acquired by bequest, devise, or
inheritance, or by the decedent's estate from
the decedent, the basis shall be the fair
market value of such property at the time
of such acquisition. In the case of property
acquired at any time prior to the death of
the decedent, the basis of such property in the
hands of the persons entitled to it under the
circumstances that the possession or enjoyment
of the property was, at the date of death of
the decedent, the basis of such property
is the death of the decedent. For ex-
ample, if, after the death of a decedent,
the basis of property in the hands of the
executor of the decedent's estate is the fair
market value at the time of such acquisition,
and the executor distributes the property
to the beneficiaries of the decedent's
estate under the will, the basis of the
property received by the beneficiaries
is the fair market value at the time
of distribution, which will be the
date of death of the decedent.
(b) Basis.—The basis of property
transmitted at death is the fair market
value at the time of such property
is received, including the
increase or decrease in the
cost of the property; the basis
of property
transmitted at death is the fair market
value at the time of such acquisition.
In the case of property
cquired by bequest, devise, or
inheritance, or by the decedent's estate
the basis
of such property
is the death of the decedent. For ex-
ample, if, after the death of a decedent,
the basis of property in the hands of the
executor of the decedent's estate is the fair
market value at the time of such acquisition,
and the executor distributes the property
in the hands of the beneficiaries
is the fair market value at the time
of distribution, which will be the
date of death of the decedent.
(c) Basis (adjusted) of property.
The basis of property transmitted at death is
the fair market value at the time of
such acquisition, increased by any
income realized by the decedent during
his lifetime that is includible in gross
income for the purpose of determining
the tax imposed by chapter 112, or
decreased by any expenses incurred by
the decedent during his lifetime that
are deductible for the purpose of
determining the tax imposed by chapter
112.
decendant by will or under the law governing decendant and distribution of property of decedents, where such for- eign corporation with respect to its taxable year next preceding the date of the decedent's death was a foreign personal holding company, is the fair market value of such stock at the time of such acquisition, i.e., the date of the decedent's death, or the basis in the hands of the decedent (with proper adjustments to the date of the decedent's death), whichever is lower.

(c) Fair market value.—For the purposes of this article, the value of property as of the date of the death of the decedent as appraised for the purposes of the Federal estate tax or if the property is not appraised as of the date of death of the decedent for such purpose or if the estate is not subject to such tax, its value as appraised as of the date of the death of the decedent for the purpose of State inheritance or transmission taxes, shall be deemed to be its fair market value at the time of the death of the decedent.

(d) Property acquired before March 1, 1913; reinvestments by fiduciary.—If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 113 (a) (14).

(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 term of any trust created 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 (1) and section 23 (m), to a legal heir 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 in the hands of the trust beneficiaries and the trust estate, 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, 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 decedent's heir, legatee, devisee, or other person to whom a uniform basis under this article is applicable shall make and maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by him, and shall furnish to the Commissioner information with respect to such matters in such detail at such time and in such manner as the Commissioner may require.

(f) Sales of remainder and other interests in property transmitted at death.—The following is an illustration of the rule stated in paragraph (b) of this article that, under section 113 (a) (5), the measure of gain or loss resulting from a sale or other disposition of property transmitted at death is the increase or decrease in the value of the property as reflected in such sale or other disposition:

If land is left for life to A, with remainder in fee to B, and prior to A's death, B sells his remainder, the increase or decrease in the value of the land reflected, and realized by B, in the proceeds from the sale of his remainder interests 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 or other disposition:

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.]

(1) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(2) Tax-free exchanges generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b), gain or loss shall be determined as provided in paragraph (15), (17), or (18) of this subsection shall be the same as in the case of the property acquired in the amount of any money received by the taxpayer and increased in the amount of any money paid by the taxpayer that was recognized upon such exchange under the law applicable to the exchange the decedent made, as respects to which one of the persons to whom the same uniform basis is applicable made 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 proceeds (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as consideration for the transfer of the property to it.

Art. 113 (a) (6)–1. Property acquired upon a tax-free exchange.—In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112 (b), if no gain or loss was recognized under the law applicable to the year in which such 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 as the cost of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. For example: A purchased a share of stock in the X Corporation In 1926 for $100. Pursuant to an organization, A In 1938 exchanged his share for one share in the Y Corporation, worth $50, and $30 in cash. Under the provisions of section 112 (c), A realized a taxable gain of $20 from the exchange. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the share of stock in the Y Corporation is $90; that is, the basis of the share in the X Corporation ($100) less the amount of money received by A ($30) plus the amount of gain recognized on the exchange ($20).

If, upon an exchange of properties of the type described in section 112 (b), there was received by the taxpayer in addition other property (not permitted to be received without the recognition of gain and money, and gain from the transaction was recognized under section 112 (c) or (d) or a similar provision of a prior Revenue Act, the basis (adjusted to the date of the ex-
change of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized upon the disposition of this property, 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 each property acquired an amount equivalent to its fair market value at the date of the exchange.

Example: A purchased a share of stock in the X Corporation in 1924 for $100. Upon a reorganization of the X Corporation in 1938, A received in place of his stock in the X Corporation a share of stock in the Y Corporation worth $60, a Treasury bond worth $50, and in addition $20 in cash. Under section 112 (c) (1), A realized a gain of $30 from the exchange. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the property received in exchange is the basis of the old stock ($100) decreased in the amount of money received ($20) and increased in the amount of gain that was realized ($30), with the result that A has a basis of $50 in the property received. This basis of $110 is apportioned between the Treasury bond and the share of stock, the basis of the Treasury bond being its fair market value at the date of the exchange, $50, and of the share of stock, the remainder, $60.

Section 112 (e) of the Act, and similar provisions of prior Revenue Acts, provide that no loss may be recognized on an exchange of properties of a type described in section 112 (b), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties received by the taxpayer (other than money) is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received and increased by the amount of gain recognized upon the disposition of the property. The basis must be apportioned to the properties received, and for this purpose there must be allocated to such other property (not permitted to be exchanged tax-free) an amount of such basis equivalent to the fair market value of such other property at the date of the exchange.

Paragraph (6) of section 113 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration recognized, unless acquired by such corporation as a party to a reorganization as defined in section 112, except that property acquired 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 such corporation as a party to a reorganization after the transfer an interest or control in such property; except that—

(a) (7) Transfers to corporation.—If the property was acquired after December 31, 1917, and in a taxable year beginning January 1, 1936, by a corporation in connection with a readjustment, and immediately after the transfer an interest or control in such property of 50 percent or more remained in the same person or entity, 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 transferee, increased in the amount of gain or decreased in the amount of loss recognized on the transfer, at the time the transferor made the gain or loss which was recognized on the transfer under the law applicable to the year in which the transfer was made. Paragraph (7) shall not apply if the property acquired 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 such corporation as a party to a reorganization after the transfer an interest or control in such property; except that—

(b) (8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1917, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (a) (7) (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 transferee, increased in the amount of gain or decreased in the amount of loss recognized on the transfer, in the hands of the transferee, as the cost of such property, except that—

(c) Basis (unadjusted) of property.—The basis of properties transferred in the same transaction may be allocated to such other property at the date of the transfer, in the hands of the transferee, as the cost of such property, except that—

[Sec. 113, Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]

(7) Transfers to corporation.—If the property was acquired after December 31, 1917, and in a taxable year beginning January 1, 1936, by a corporation in connection with a readjustment, and immediately after the transfer an interest or control in such property of 50 percent or more remained in the same person or entity, 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 transferee, increased in the amount of gain or decreased in the amount of loss recognized on the transfer, at the time the transferor made the gain or loss which was recognized on the transfer under the law applicable to the year in which the transfer was made. Paragraph (7) shall not apply if the property acquired 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 such corporation as a party to a reorganization after the transfer an interest or control in such property; except that—

(b) (8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1917, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (a) (7) (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 transferee, increased in the amount of gain or decreased in the amount of loss recognized on the transfer, in the hands of the transferee, as the cost of such property, except that—

(c) Basis (unadjusted) of property.—The basis of properties transferred in the same transaction may be allocated to such other property at the date of the transfer, in the hands of the transferee, as the cost of such property, except that—

[Sec. 113, Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]
Example: A vessel purchased by A in 1926 for $100,000 is destroyed in 1938 and A receives insurance in the amount of $200,000. Disregarding for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

Example (1): A purchased a share of common stock of the X Corporation for $100 in 1926, which he sold January 15, 1938, for $80. On February 1, 1938, he purchased a share of common stock of the same corporation for $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) less the excess of the price at which the old share was sold ($80) over the price at which the new share was purchased ($70).

Section 113. Adjusted basis for determining gain or loss.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(9) Involuntary conversion.—If the property was the subject of an involuntary conversion described in section 112 (f) of this Act or the Revenue Act of 1928, $100

(10) Wash sales of stock.—If the property consists of stock or securities the acquisition of which was made or an option to acquire which resulted in the nonadmissibility (under section 118 of this Act or corresponding provisions of income tax law relating to wash sales) of the loss from the sale or redemption 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.

Ann. 113 (a) (10)–1. Stock or securities acquired in "wash sales."—The application of section 113 (a) (10) may be illustrated by the following examples:

Example (1): A purchased a share of common stock of the X Corporation for $100 in 1926, which he sold January 15, 1938, for $80. On February 1, 1938, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 118. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2): A purchased a share of common stock of the Y Corporation for $100 in 1924, which he sold January 15, 1938, for $80. On February 1, 1938, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 118. The basis of the new share is $90; that is, the basis of the old share ($100) less the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

Section 113. Adjusted basis for determining gain or loss.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(11) Property acquired during affiliation.—In the case of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. Where a corporation transactions in respect of which a gain or loss was not recognized for the purpose 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 after the period of affiliation, unless a consolidated return was made, or was required under Regulations 102, relating to consolidated returns, shall be determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. Where a consolidated return was made, or was required under Regulations 102, relating to consolidated returns, the basis 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 was made or is required under Regulations 102, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

The basis of property after a consolidated return period shall be the same as immediately prior to the close of such period. For example, if a corporation has been a member of an affiliated group which has made a consolidated return on the calendar year basis for the taxable year 1937 and makes a separate return for the taxable year 1938 and succeeding taxable years, the value of the opening inventory to be used in computing such corporation's net income for the taxable year 1938 is the proper value of the closing inventory used in computing the consolidated net income for the preceding taxable year.

Section 113. Adjusted basis for determining gain or loss.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(12) Basis established by Revenue Act of 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (7), (9), or (10) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

Ann. 113 (a) (12)–1. Basis of property established by Revenue Act of 1932.—Section 113 (a) (12) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the
Revenue Act of 1932, was prescribed by section 113 (a) (6), (7), or (9) of that Act, then for the purposes of the Revenue Act of 1938 the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

If, after December 31, 1933, and in any taxable year beginning before January 1, 1934, in pursuance of a plan of reorganization and without the surrender of his stock, there was distributed to a shareholder in a corporation a party to the reorganization stock or securities of a corporation a party to the reorganization, then in section 113 (a) (9) of the Revenue Act of 1932, the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the new shares or securities shall be determined in accordance with the following rules:

1. If the stock distributed in reorganization consists solely of stock in the distributing corporation and is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of the old share shall be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

2. If the stock distributed in reorganization is in whole or in part stock in a corporation a party to the reorganization other than the distributing corporation, or where the stock distributed in reorganization is in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists wholly or partly of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or securities, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions, securities are different in class from stocks and stocks or securities in one corporation are different in class from stocks or securities in another corporation. In general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class.

3. If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the identity of the lots cannot be determined, any sale of the original stock will be charged to the earliest purchases of such stock (see article 22 (a)–(g)), and any sale of the stock or securities distributed in reorganization will be presumed to have been from the stock or securities distributed in respect of the earliest purchased stock.

4. If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the identity of the stock or securities distributed in reorganization cannot be determined 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, 1933, without the surrender of his stock there is acquired by a shareholder 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 in respect of each share will be treated as a dividend to the extent described in article 112 (g)–(j).

[Sec. 113. Adjusted basis for determining gain or loss.]

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property, except that—

(1) 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 transferee, increased in the amount of gain or decreased in the amount of loss recognized to the extent of the transferor’s interest in the property under the partnership interest prevailing on which the income tax has been paid.

(2) If partnership property increased in the amount it would be in the hands of the transferee, diminished in the amount of any gain or loss sustained, or the facts as to such change in basis would have been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in article 111–1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change in basis or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

[Sec. 113. Adjusted basis for determining gain or loss.]

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property except that—

(15) Property acquired before March 1, 1913.—In the case of property acquired before March 1, 1913, the basis otherwise determined under this subsection (for the period prior to March 1, 1913) is less than the fair market value of the property at the date of transfer to the partnership, the annual depletion or depreciation allowances shall be allocated to and included in the determination of the distributive share of the partners in accordance with their agreement in respect of the sharing of gains or losses among the contributing partners. If the basis of such contributed property is less than the fair market value thereof of 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 in 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.

Ann. 113 (a) (13)–(2). Reassessment 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 as hereinafter 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 29, 1913, on which the income tax has been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in article 111–1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change in basis or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

[Sec. 113. Adjusted basis for determining gain or loss.]

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property except that—

(14) Property acquired before March 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection (for the period prior to March 1, 1913) is less than the fair market value of the property at the date of transfer to the partnership, the annual depletion or depreciation allowances shall be allocated to and included in the determination of the distributive share of the partners in accordance with their agreement in respect of the sharing of gains or losses among the contributing partners. If the basis of such contributed property is less than the fair market value thereof of 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 in 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.

Ann. 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 fair market value thereof, 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 property on March 1, 1913, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If it be assumed that the amount of depreciation deductions allowed (not less than the amount allowable) after February 28, 1913, to the year 1938 is in the aggregate sum of $43,240, the adjusted basis for determining gain in 1938 ($94,000 less $43,240) is $50,760. (b) For the purpose of determining a loss from the sale or other disposition of such property in 1938, the basis of the property is the cost of the property, without reference to the fair market value as of March 1, 1913, adjusted for depreciation for the period subsequent to March 1, 1913, and after February 28, 1913. The amount of depreciation sustained prior to March 1, 1913, in this example is $10,000, and if the amount of depreciation to be accounted for after February 28, 1913, is assumed to be $43,240, the aggregate amount of depreciation for which adjustment of such cost must be made is $53,240. The adjusted basis for determining the loss in 1938 ($100,000 less $53,240) is $46,760.

What the fair market value of property was on March 1, 1913, is a question of fact to be established by competent evidence. In determining the fair market value of a corporation at the date of its complete liquidation, due regard shall be given to the fair market value of the corporate assets on such date. In the case of property traded in on public exchanges, actual sales at or about the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced sale price or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time, but such value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in every case.

[Sec. 113. Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]

(16) Property received by a corporation on complete liquidation of another corporation.—Except as otherwise provided in this article, the basis of property included 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.

[Sec. 113. Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]

(18) Basis established by Revenue Act of 1934.—If the property was acquired, after January 1, 1935, in any taxable year beginning prior to January 1, 1936, and the basis thereof, for the purpose of the Revenue Act of 1934 was prescribed by section 113 (a) (8), (7), (5), or (6) of that Act, then for the purposes of the Revenue Act of 1934 the basis shall be the same as the basis therein prescribed for the Revenue Act of 1934.

Art. 113 (a) (16) 1. Basis of property received by a corporation in complete liquidation of another corporation.—Except as otherwise provided in this article, the basis of property included 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, except that—

(1) Such property was received in a liquidation which was completed before June 23, 1936;

(2) Such liquidation constituted a complete liquidation within the meaning of section 112 (b) (6) of the Revenue Act of 1934, as amended, by the Revenue Act of 1935;

(3) No gain or loss would have been recognized under section 112 (b) (6) of the Revenue Act of 1934, as amended, upon the receipt of such property; and

(d) The recipient corporation (within 180 days after the enactment of the Revenue Act of 1935) under regulations prescribed under section 808 elected to have such basis apply to such property.

If such an election was made, the basis of such property received in liquidation shall be the cost or other basis (adjusted as provided in section 113) of the stock of the liquidating corporation surrendered in exchange for the property, decreased in the amount of money received and increased in the amount of gain or decreased in the amount of loss to the recipient corporation that was recognized upon the liquidation under the Revenue Act of 1936. If such property consists of more than one class of property the basis shall be allocated among the several properties (other than money) received, in the proportion that the fair market value of each such property as of the date of distribution bears to the fair market value of all such properties on that date.

[Sec. 113. Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]

(18) Basis established by Revenue Act of 1934.—If the property was acquired, after January 1, 1935, in any taxable year beginning prior to January 1, 1936, and the basis thereof, for the purpose of the Revenue Act of 1934 was prescribed by section 113 (a) (8), (7), (5), or (6) of that Act, then for the purposes of the Revenue Act of 1934 the basis shall be the same as the basis therein prescribed for the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning prior to January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112 (b) (5) of the Act but which is described in section 112 (b) (6) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

[Sec. 113. Adjusted basis for determining gain or loss.]

[(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—]

(17) Property acquired in connection with exchanges and distributions in obedience to orders of Securities and Exchange Commission.—If the property was acquired in any manner described in section 971, the basis shall be that prescribed in such section with respect to such property.

(18) Property received in certain corporate liquidations.—If the property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock in 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 (a) (8), such gain was not recognized, then the basis shall be the same as the basis of such stock canceled or redeemed in the liquidation, decreased in the amount of any money received by him, and increased in the amount of such gain recognized to him.

Art. 113 (a) (18) 1. Basis of property received in certain corporate liquidations.—(a) Property included.—Section 113 (a) (18) applies only to property (other than money) acquired by a qualified electing shareholder, (2) upon a distribution in complete liquidation of
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 (2) 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 realized 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 amount of cash, property (other than stock or securities acquired after April 9, 1938, and 100 shares of stock owned by a person for whom the basis is to be determined) in the liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after April 9, 1938) with a fair market value of $12,000, and stock acquired by the liquidating corporation after April 9, 1938, with a fair market value of $4,000. The basis of the shares owned by A was $100 per share, or $10,000. A's ratable share of the earnings and profits of the X Corporation accumulated after February 28, 1913 (computed as provided in section 112 (b) (7)), was $7,500. His gain is $7,500, but under section 112 (b) (7) only $5,000 of this gain is recognized, $2,500 thereof being taxed as a dividend.

The basis of all the property other than money received by A is $14,000, computed as follows:

| Adjusted basis of stock canceled or redeemed | $10,000 |
| Remaining | 1,000 |
| Plus gain recognized | 9,000 |
| 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 $10,000, to the property of a transferor corporation, 4,000/16,000 of $14,000, or $3,500, to the stock.

Section 119. Adjusted basis for determining gain or loss.

(b) Adjusted basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General rule.—Proper adjustment in respect of the property shall be made in all cases in which self-employment income is reported on the tax return of the owner of such property.

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years, the adjusted basis of such property is the fair market value thereof as of the date of acquisition, decreased in the proportion that the fair market value of such property bears to the adjusted basis of such property as of the date of acquisition.

(B) The basis of property acquired in a 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 (2) 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 realized 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.

(1) Adjusted basis.—The adjusted basis of property acquired shall be determined in accordance with the rules prescribed in paragraph (1) of this subsection, provided in paragraph (1) of this subsection shall be made after first making in respect of the same property all other adjustments, including any adjustment for a similar nature in respect of the period during which property was held by the transferor, 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.

(2) 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) General rule.—Proper adjustment in respect of the property shall be made in all cases in which self-employment income is reported on the tax return of the owner of such property.
his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. For example, the case of Corporation A discloses the following facts as of January 1, 1938:

<table>
<thead>
<tr>
<th>Year</th>
<th>Allowed</th>
<th>Allowable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>1932</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>1933</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td>1934</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>1935</td>
<td>9,000</td>
<td>9,000</td>
</tr>
<tr>
<td>1936</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>1937</td>
<td>11,000</td>
<td>11,000</td>
</tr>
<tr>
<td>1938</td>
<td>12,000</td>
<td>12,000</td>
</tr>
</tbody>
</table>

The depreciation allowed but not less than the amount allowable in this example as of January 1, 1938, is $44,000, and the cost or other basis of the property is to be adjusted by that amount. The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114 (b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, and the Revenue Act of 1938, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depreciation 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 the 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 228 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 $3,000 paid out of earnings and profits of the corporation accumulated prior to March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1938 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition. But see section 117.

In the case of the stock of 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 stopped apply, as elsewhere under the Act.

Arr. 113 (b)–3. Adjusted basis: Cancellation of lien.-In addition to the adjustments provided in section 113 (b) (1) and article 113 (b)–1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B or under Chapter X, XI, or XII of the Bankruptcy Act of 1898, as amended. (See page 665 of the Appendix to these regulations.) Such further adjustment shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is imposed against the property or securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but the amount realized from the sale or other disposition shall not be more than the amount of the adjusted basis without reference to this article) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under (1) and (2) shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable) accounts receivable by (1) and (2)) as follows: The cost or other basis of each unit of property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) in an amount equal to such proportion of such excess as the adjusted basis (without reference to this article) of each such unit of property bears to the sum of the adjusted bases (without reference to this article) of all the property of the debtor other than inventory and notes and accounts receivable; and

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under (1), (2), and (3) shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this article) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable.

For the purposes of this article—

(A) Basis shall be determined as of the date of confirmation of the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(B) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(C) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return; and

(D) The phrase "indebtedness incurred to purchase" includes (1) indebtedness for money borrowed and applied in the purchase of property and (2) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay.

The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this article.

Arr. 113 (b)–3. Substituted basis.—Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2), the adjustments indicated...
in article 113 (b)–1 shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. The adjustment, if 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 1938 purchased 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 X Building, in 1938, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to C upon the Y Building, in addition to the deductions from the adjusted basis (not less than the amount allowable) to herself during her ownership of the Y Building.

CHAPTER XIV

Depreciation and Depletion

Sec. 114. Basis for depreciation and depletion.—(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence or similar impairments of a mine or other natural deposit or mineral deposit of minerals, except as provided in paragraphs (5), (6), and (7) of this subsection.

(b) Basis for depreciation.—(1) General rule.—The basis for depreciation shall be allowed in respect of property being deducted for exhaustion, wear and tear, obsolescence, and depletion 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 (5), (6), and (7) of this subsection.

(2) Discovery value in case of mines.—In the case of mines (other than metal, coal, or sulphur mines) discovered by the taxpayer in any year after February 28, 1913, the basis for depreciation 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 adjusted basis of the property (computed without allowance for depletion) from the property upon which the discovery was 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.

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 metered 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), the adjustment indicated in article 113 (b)–2 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferee, donor, or grantor.

(2) Percentage depletion for oil and gas wells.—In the case of oil and gas wells, the basis for depletion under section 23 shall be 27 1/2 per centum of the gross income from the property during the taxable year, excluding any proceeds paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 27 1/2 per centum of the net income from the property (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.

(3) Percentage depletion for coal and metal mines and sulphur.—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 10 per centum, and, in the case of sulphur mines, 15 per centum, of the gross income from the property during the taxable year, excluding any proceeds paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 20 per centum of the net income from the property (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(4) Percentage depletion for coal and metal mines and sulphur.—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 10 per centum, and, in the case of sulphur mines, 15 per centum, of the gross income from the property during the taxable year, excluding any proceeds paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 20 per centum of the net income from the property (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.

(5) Percentage depletion for oil and gas wells.—In the case of oil and gas wells, the basis for depletion under section 23 shall be 27 1/2 per centum of the gross income from the property during the taxable year, excluding any proceeds paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 27 1/2 per centum of the net income from the property (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(b) Source of distributions.—For the purpose of this Act every distribution is made out of capital gains or profits to the extent of, and from the most recently accumulated earnings and profits. Any earnings or profits accumulated after February 23, 1913, are distributable under section 112. Despite the provisions of section 117, the gain so recognized shall be determined as if the corporation had distributed in partial liquidation of a corporation shall be treated as if generally distributed in a partial liquidation of a corporation.
the liquidation of such company before such date as the Commissioner may find reasonable, but not later than December 31, 1939.

(d) Other distributions from capital.—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders in complete cancellation of its indebtedness or in exchange for property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the basis of the property accrued before March 1, 1913.

(e) Distributions by personal service corporations.—Any distribution made by a personal service corporation shall be treated as if it were a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 218 of the Revenue Act of 1921, out of its earnings or profits which were taxable in the year such stock was issued as a stock dividend.

(f) In-kind dividends.—(1) General rule.—A distribution made by a corporation to its shareholders in stock or in rights to acquire stock, whether exercised before or after such date, or on or after such date to a distributee, shall 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.—A corporation making a distribution by a corporation is, at the election of any of its shareholders (whether exercised before or after such date), permitted to make either (A) in its stock or in rights to acquire stock, of a class which if distributed without election would be taxable as a dividend under paragraph (1), or (B) in money or any other property (including its stock or in rights to receive any property of such corporation) of a class which if distributed without election would not be exempt from the tax under paragraph (1), then the distribution shall be treated as a dividend.

(g) Redemption of stock.—A corporation may cancel or redeem its stock (whether or not such stock is issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption, whole or in part, essentially equivalent to the distribution of a taxable dividend.

(h) Effect on earnings and profits of distributions of stock.—The distribution (whether before January 1, 1938, or on or after that 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 as 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, were recognized by law, or (2) if the distribution was not subject to tax in the hands of such distributee because it did not become income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 218 of the Revenue Act of 1934 or a corresponding provision of any 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 term "amounts distributable in partial liquidation" means a distribution by a corporation in complete cancellation of a portion of its stock, or one of a series of distributions in complete cancellation or redemption of all or part of its stock.

(j) Valuation of dividend.—If the whole or any part of a dividend is paid to a shareholder in property other than money the property received other than than money shall be included in gross income at its fair market value at the time at which it becomes income to the shareholder.

(k) Consent distributions.—For taxability as dividends the whole or any part shall be included in gross income by shareholders' consents, see section 28.

Art. 115-1. Dividends.—The term "dividend" for the purpose of Title I (except when used in sections 203 (a) and 207 (c) (1) thereof) comprehends any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits of the taxable year computed toward 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 year.

For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

A taxable distribution made by a corporation to 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 tax year 1938, the M Corporation had an operating deficit of $200,000 and the earnings or profits from the operations of the M Corporation contributed to the earnings of that year, out of its earnings or profits, accumulated prior to March 1, 1913, and available on the date of the distribution. The corporation made quarterly distributions during the taxable year in the amounts of $25,000 each. Each distribution is a taxable dividend, irrespective of the actual or the proportion amount of the earnings or profits on hand at any of the dates of distribution. Therefore, the total distributions made during the year ($100,000) did not exceed the total earnings or profits of the year ($100,000).

Art. 115-2. Sources of distributions. 115-5. Income tax general.—For the purpose of income tax the distribution made by a corporation is a taxable dividend, irrespective of the actual or the proportion of the earnings or profits on hand at any of the dates of distribution and the amount of the earnings or profits of the year ($100,000).
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:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
<th>Portion out of earnings or profits accumulated since February 28, 1913 (or (1) if the distribution was made on or after January 1, 1913)</th>
<th>Portion out of earnings or profits accumulated prior to February 28, 1913, and prior to taxable year (or (2) if the distribution was made prior to January 1, 1913)</th>
<th>Total amount taxable as dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 10</td>
<td>$15,000</td>
<td>$7,000</td>
<td>$4,500</td>
<td>$15,000</td>
</tr>
<tr>
<td>June 10</td>
<td>15,000</td>
<td>7,000</td>
<td>4,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Sept. 10</td>
<td>15,000</td>
<td>7,000</td>
<td>4,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Dec. 10</td>
<td>15,000</td>
<td>7,000</td>
<td>4,500</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Title I.

Art. 115-3. Earnings or profits.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under state law. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion is a factor in the determination of income, the only depletion deductions to be considered in the computation of earnings or profits are those based on (1) cost or other basis, if the depletable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost or March 1, 1913, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery and percentage depletion under all Revenue Acts for mines and oil and gas wells should not be taken into consideration in computing the earnings or profits of a corporation.

A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year. However, in determining the earnings or profits accumulated since February 28, 1913, the excess of a loss sustained prior 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, such distributions, if declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

Art. 115-4. Distributions other than a dividend.—Under section 115 (d), any distribution (including a distribution out of earnings or profits accumulated before March 1, 1913) other than

(1) a dividend (see articles 115-1 and 115-2),

(2) a distribution out of increase in value of property accrued prior to March 1, 1913 (see article 3-1), or

(3) a distribution in partial or complete liquidation (see article 115-5) shall be applied against and reduce the adjusted basis of the stock provided in section 113 and shall be taxable to the recipient if, and to the extent that, such distribution exceeds such basis. The provisions of this article are applicable to such distributions received by one corporation from another corporation.

Example: In 1938 the M Corporation purchased certain shares of stock in the O Corporation for $10,000. During that year the M Corporation received a distribution from the O Corporation of $2,000 paid out of earnings or profits of the O Corporation accumulated prior to March 1, 1913. This distribution must be applied by the M Corporation against the basis of its stock in the O Corporation reducing such basis to $8,000. The $2,000 does not constitute a part of the earnings or profits of the M Corporation.

If the M Corporation subsequently sells the stock of the O Corporation for $9,000, it realizes a gain of $1,000, which constitutes a part of its earnings or profits for the year in which the stock is sold.

If the distribution had amounted to $10,000, the gain of $4,000 would be taxable to the M Corporation and would have constituted a part of the earnings or profits in the year in which the distribution was made.

Art. 115-5. Distributions in liquidation.—(a) General.—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment of the entire capital stock of the corporation. All amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

(b) Complete liquidation.—In the case of amounts distributed in complete liquidation of a corporation, the amount of the gain or loss so recognized is subject in general to the limitations contained in section 117. For this purpose the term "complete liquidation" includes any one of a series of distributions of property from a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not amounting from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning prior to January 1, 1933.

For the purposes of the last sentence of section 115 (a), a liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed from the liquidating corporation and the receiver or trustee in liquidation are finally divested of all the property (both tangible and intangible).

For the purpose of this article the determination of whether a foreign corporation was a foreign personal holding company with respect to a taxable year beginning on or before, and ending after August 26, 1937, shall be made under section 331 of the Revenue Act of 1936, added to such Act by section 201 of the Revenue Act of 1937, and articles 331-1, 331-2, and 331-3, respectively, added to Regulations 94 by Treasury Decision 4762, approved December 7, 1937 (C. B. 1937-2, p. 163).

Example: A, an individual whose taxable year is the calendar year, owns 20 shares of stock of the N Corporation, a domestic corporation, 10 shares of which were acquired in 1934 at a cost of $4,250 and the balance of 10 shares in June.
1936, at a cost of $3,000. He receives in May, 1938, a distribution of $200 per share in complete liquidation, or $2,000 on the 10 shares acquired in 1924. The gain of $750 on the shares acquired in 1924 should be included in A’s gross income to the extent of 50 percent, or $375; the loss of $1,000 on the shares acquired in 1936 should be deducted in computing A’s net income to the extent of 66 2/3 percent, or $666.67. (See section 117 (b). See also section 117 (c).)

(c) Partial liquidation.—In the case of amounts distributed in partial liquidation of a corporation, the amount of the loss recognized is subject to the limitations contained in section 117 but the amount of the gain recognized shall be considered as a short-term capital gain despite the provisions of section 117. The term “amounts distributed in partial liquidation” means a distribution by a corporation in complete liquidation 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 considered, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining taxability of subsequent distributions by the corporation. (See articles 27 (g)–1 and 115–11.)

Example: A, an individual whose taxable year is the calendar year, owns 20 shares of participating preferred stock of the Y Corporation, 10 shares of which he purchased in 1924 for $1,060 and 10 shares of which he purchased in June, 1936, at $2,000. On May 15, 1938, the corporation in a transaction qualifying as a partial liquidation redeemed the entire issue of preferred stock by paying the holders $314 per share. A receiving $2,620 upon the surrender of his 20 shares of such stock. The gain of $350 on the shares acquired in 1924 should be included in its entirety in A’s gross income; but the loss of $590 on the shares acquired in 1936 should be deducted in computing A’s net income to the extent of 66 2/3 percent, or $393.33. (See section 117 (b). See also section 117 (c).)

Art. 115–6. Distributions from depletion or depreciation reserves.—A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets covered by the reserve 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 and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in article 111–1. A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholder, 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 allowance for any prior year, 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 rather than a tax upon which declared. (See article 111–1. No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed. (Art. 115–7. Stock dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.3 The distinction between a stock dividend which does not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which is the result of a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share. On July 1, 1938, the X Corporation declared an annual dividend on the preferred stock of 7 percent, or $7000, paid in cash, and at the option of the corporation, in common stock of $100 par value for each share of preferred. On July 1, 1938, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $65,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to $15,000. On July 1, 1938, it distributed 1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock, thereby paying a stock dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (2): On July 1, 1938, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1938, the Y Corporation issued and divided among its shareholders 200 additional shares of its common stock of a total par value of $20,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (3): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent cumulative

The holder specifically requests payment in whole or in part, in stock or rights to acquire 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, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution 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 a 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.

If the whole or any part of the dividend is paid to a shareholder as a distribution, the portion of such distribution the property received other than money shall be included in gross income at its fair market value at the time of which it becomes income to the shareholder. (See article 42-3.)

A distribution in a taxable year (beginning before January 1, 1936, or on or after such date) of stock or securities, or other property or money, to a complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1935 or section 112 (b) (5) of the Revenue Act of 1913, is essentially equivalent to the distribution of a taxable dividend.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to an order of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributees 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 (7) of the Revenue Act of 1928 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this article, the terms "reorganization" and "party to the reorganization," to its shareholders of stock or securities in such corporation, or in another corporation a party to the reorganization—

(A) In any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1923) ; or

(B) In any taxable year (beginning before January 1, 1936, or on or after such date) of stock or securities, or other property or money, to a complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1935 or section 112 (b) (5) of the Revenue Act of 1913.
reorganization" shall, for any taxable year beginning before January 1, 1934, have the meaning 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, the meanings assigned to such terms in section 112 of the Revenue Act of 1934; and for any taxable year beginning after December 31, 1933, and before January 1, 1936, the meaning assigned to such terms in section 112 of the Revenue Act of 1936.

CHAPTER XV

Additional Exclusions From Gross Income

Sec. 116. Exclusions from gross income. In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this title:

(c) Earned Income from sources without United States. In the case of a citizen of the United States, income derived from any public utility, or from any source within the United States, or any political subdivision thereof, in pursuance of any contract entered into before the enactment of the Revenue Act of 1928, is to be paid out and the rates prescribed in this title, but there would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax upon the net income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title.

(d) 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.

(e) Income of State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, in pursuance of any contract entered into before the enactment of the Revenue Act of 1928, is to be paid out and the rates prescribed in this title, but there would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, and the proceeds from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title.

(f) Dividends from "China Trade Act" corporations. In the case of a person, amounts distributed to him for his benefit by a corporation organized under the "China Trade Act," 1922, if, at the time of such distribution, he is a resident of China, and the equity or the interest of the shares of stock of the corporation is in good faith vested in him.

(g) Shipowners' protection and indemnity associations. The income of such associations on behalf of shipowners in 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 similar services.

(h) Compensation of employees of foreign governments. (1) Rule for exclusion. Wages, fees, or salary of an employee of a foreign government, consular or other officer, or a nondenominational representative, received as compensation for official services to such government:

(A) If such employee is not a citizen of the United States or of any foreign country;

(B) If the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

(C) If the foreign government whose exemption from taxation grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.

(2) Certificate by Secretary of State. The Secretary of State shall certify to the Secretary of the Treasury the names of such foreign governments which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

Art. 116-1. Income of foreign governments, ambassadors, and consuls. The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are privately owned but are loaned to such foreign governments, is subject to tax. Ambassadors and ministers accredited to the United States and the members of their households (including secretaries, attachés, and servants) who are not citizens of the United States, are exempt from the payment of the tax upon their salaries, fees, or wages. Their income from all sources other than a business carried on by them in the United States is also exempt. These provisions are also applicable to the wives and minor children of foreign ambassadors and ministers and the members of their households, including secretaries, attachés, and servants.

All employees of a foreign government (including consular or other officers, or nondenominational representatives) who are not citizens of the United States are exempt from Federal Income Tax, except 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 the employees of the Government of the United States performing similar services in such foreign country. Section 116 (h) (2) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries. The income received by employees of foreign governments (including consular or other officers, or nondenominational representatives) received as compensation for official services to such government—
governments (other than ambassadors, ministers and members of their households including secretaries, attaches and servants) from sources other than their salaries, fees, or wages, referred to above, is subject to Federal income tax. The compensation of the United States who are officers or employees of a foreign government is not exempt from income tax. (See page 660 of the Appendix to these regulations.)

Art. 116-2. Compensation of State officers and employees—Compensation received for or incurred by a State is to be included in gross income unless the person receives such compensation from the State as an officer or employee thereof and such compensation is immune from taxation under the Constitution of the United States.

One is not an officer or employee of a State merely by reason of rendering services to the State and receiving compensation therefor. Persons employed by a State, under a contract for the rendering of services of a special nature, such as those performed by a consulting engineer who is employed as a State consultant subject to water supply or sewage disposal systems, whose duties are prescribed by the contract and whose work is not of a permanent or continuous character, are not officers or employees of the State.

If all or part of the compensation of an officer or employee of a State is paid directly or indirectly by the United States, such compensation (or part) is taxable, as, for example, any compensation paid by the United States to officers of the National Guard of a State, or compensation paid by a State to officers or employees employed by a foreign government or college wholly or partly out of grants from the United States.

The commissions of receivers appointed by the State courts and the fees received by notaries public are taxable. As used in this article, the term "State" includes a political subdivision of a State.

Art. 116-3. Bridges to be considered State or political subdivisions.—(1) Any State or political subdivision thereof claiming a refund under the provisions of section 116 (e) of an amount equal to all or a portion of any income tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of a State are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 116 (e) and this article is not considered an overpayment within the meaning of section 614 of the Revenue Act of 1926 (paragraph 42 of the Appendix to these regulations), relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(3) A check or voucher in payment of a claim for refund allowed under section 116 (e) will be drawn in the name of the fiscal officer or officers having authority, and in accordance with paragraph (1) hereof, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in that section and this article.

CHAPTER XVII

Capital Gains and Losses

Sec. 117. Capital gains and losses.—(a) Definitions.—As used in this title—

(1) Capital gain.—The term "capital gain" means property (whether or not connected with the trade or business), but does not include stocks in trade of the taxpayer or of a corporation in which the taxpayer would be included in the inventory of the taxpayer if on hand as the beginning of the taxable year. Any gain from the sale or exchange of such property as is realized through a transaction by the taxpayer primarily for sale to customers in the ordinary course of the trades or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 213 (a).

(2) Short-term capital gain.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income.

(3) Long-term capital gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income.

(4) Long-term capital loss.—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income.

(5) Short-term capital loss.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income.

(6) Net short-term capital gain.—The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the sum of (A) short-term capital losses for the taxable year, plus (B) the net short-term capital losses for the preceding taxable year, to the extent brought forward to the taxable year under subsection (c).

(7) Net short-term capital loss.—The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

(8) Net long-term capital gain.—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

(9) Net long-term capital loss.—The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, unless the following percentages of the gain or loss recognized upon the sale or ex-
change of a capital asset shall be taken into account in computing net income:
100 per cent if the capital asset has been held for not more than 18 months; 85½ per cent if the capital asset has been held for 18 months but not for more than 24 months; 50 per cent if the capital asset has been held for more than 24 months.

(c) Alternative taxes—(1) In case of net long-term capital gain.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, all such gains 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 the amount of the gain is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner prescribed by this section, and the total tax shall be the partial tax plus 30 per cent of the net long-term capital gain.

(2) In case of net long-term capital loss—If for any taxable year a taxpayer (other than a corporation) sustains a net long-term capital loss, all such losses shall be treated as losses in computing net income:

A partial tax shall first be computed upon the net income increased by the amount of the net long-term capital loss, by treating such losses as credits, and in case such net income has not been computed, and the total tax shall be the partial tax plus 30 per cent of the net long-term capital loss.

(d) Limitation on capital losses.—(1) Corporations.—In the case of a corporation, losses from exchanges of capital assets shall be allowed to the extent of $2,000 plus the gains from such sales or exchanges. The amounts so determined shall be treated as losses in computing the net income of the United States or any State on which a substantial part of whose business is the receipt of deposits, sells any bond, debenture, etc., the losses from such sales or exchanges are computed without reference to, or allowance for, the income tax imposed by this act. For the purposes of determining the period for which such property was held by any corporation, the period for which any corporation sustains a net short-term capital loss in any taxable year to the extent brought forward under section 117 (e) shall be computed from the date of such sale to customers in the ordinary course of business to the extent that such gain or loss is allocable to the land the limitations of which are subject to the provisions of section 113, but shall not be included in computing the net short-term capital gain, at the rates determined as follows, if and only if the amount of the capital loss is less than the tax imposed by such sections:

(2) Other taxpayers.—In the case of a taxpayer other than a corporation, short-term capital losses shall be allowed only to the extent of short-term capital gains.

(e) Net short-term capital loss carry-over.—If any taxpayer (other than a corporation) sustains a net short-term capital loss in any taxable year and does not have sufficient amounts to make the gain from the sale or exchange of real property used in the trade or business to the extent that such gain is allocable to the land, as distinguished from depreciable improvements upon the land. To such gain or loss allocable to the land the limitations of sections 117 (b), (c), and (d) apply (such limitation may be inapplicable to a dealer in real estate, but, if so, it is because he holds the land primarily for sale to customers in the ordinary course of his trade or business, not because land is subject to a depreciation allowance).

Gains or losses from the sale or exchange of property used in the trade or business of the taxpayer is subject to the limitations on losses provided in section 117 (e) and allowed under section 117 (e) shall not be included in determining the period for which such property was held by any corporation, the period for which any corporation sustains a net short-term capital loss in any taxable year to the extent brought forward under section 117 (e) shall be computed from the date of such sale to customers in the ordinary course of business to the extent that such gain or loss is allocable to the land the limitations of which are subject to the provisions of section 113, but shall not be included in computing the net short-term capital gain, at the rates determined as follows, if and only if the amount of the capital loss is less than the tax imposed by such sections:

In the definition of “net short-term capital gain,” as provided in section 117 (a) (6), reference is made in clause (B) thereof, to the net short-term capital loss of the preceding taxable year to the extent brought forward under section 117 (e). The amount so provided for is the net short-term capital loss carry-over, which is treated in the taxable year in question as a short-term capital loss. In this computation, the carry-over enters into the computation of the net short-term capital gain only in case (B). The amount thereof is not to be included under clause (A) of section 117 (a) (6). Thus, for the purposes of clause (B), the short-term capital losses for the taxable year are computed without reference to, or allowing for, the amounts provided for in subsection (e). For example, during the taxable year 1939 an individual has a short-term capital gain of $11,000 and a short-term capital loss in that year of $4,000. During the taxable year 1938 he sustained a net short-term capital loss of $2,500 which was in excess of his net income for that year. His net short-term capital gain for the taxable year 1939 is computed as follows:

1939 short-term capital gain

$11,000

Less:

1939 short-term capital loss to be allowed under section 117 (a) (6) $4,000

Net short-term capital gain of proceeding taxable year to extend brought forward under section 117 (e) and allowed under section 117 (e) $2,500

Net short-term capital gain for 1939 $3,500
In the case of individuals, gains and losses from the sale or exchange of capital assets held for not more than 18 months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of capital assets held for more than 18 months (described as long-term capital gains and long-term capital losses). This segregation is applicable only to the capital gains and capital losses of individuals and does not apply to corporations. 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 of section 117 (d) such losses may not be deductible in full).

See section 23 (g) and (b), 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.

Ann. 117-2. Percentage of capital gain or loss taken into account: Net loss carry-over.—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. For instance, if unimproved real estate purchased by an individual for $20,000 is a capital asset and is sold by him for $25,000 after having been held for more than two years, only 50 percent of the recognized gain ($5,000), or $2,500, shall be taken into account in computing net income; or if such property is sold for $14,000, only 50 percent of the recognized loss ($6,000), or $3,000, shall be so taken into account.

Section 117 (d) (1) provides a limitation on deductions for capital losses affecting corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales or exchanges. However, in the case of certain banks or trust companies, this limitation is subject to the modification provided in that section. Section 117 (d) (2) provides a further limitation on deductions for short-term capital losses of taxpayers other than corporations, that is, losses from sales or exchanges of capital assets held for 18 months or less shall be allowed as deductions only to the extent of the gains from sales or exchanges of capital assets held for 18 months or less. However, subsection (c) of section 117 provides that a taxpayer (other than a corporation) having in any taxable year (beginning after December 31, 1937) a net short-term capital loss, may carry over such loss, in an amount not in excess of his net income for such year (the year in which the loss is realized), to the next succeeding taxable year and treat it in such succeeding year as a short-term capital loss. The carry-over is thus applied in such succeeding year to offset any short-term capital gains in such succeeding year not already offset by short-term capital losses in such year. The carry-over is restricted to one year, namely, the succeeding taxable year, and hence the amount of the net short-term capital loss carry-over may not be included in computing a new net short-term capital loss which can be carried over to the second succeeding taxable year.

The practical operation of the provisions of this article may be illustrated by the following examples:

Example (1): During the taxable year 1938, A, an individual, has ordinary net income (net income exclusive of gains or losses from sales or exchanges of capital assets) of $6,000 and gains and losses resulting from sales or exchanges of capital assets as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Gain</th>
<th>Loss</th>
<th>Percentage of Capital Gain or Loss Exceeded by Gain</th>
<th>Amount Taken into Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation stock</td>
<td>$10,000</td>
<td></td>
<td>100%</td>
<td>$10,000</td>
</tr>
<tr>
<td>Corporation bonds</td>
<td>$12,000</td>
<td></td>
<td>95%</td>
<td>$11,500</td>
</tr>
<tr>
<td>Government bonds</td>
<td>0</td>
<td>5,000</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>0</td>
<td>7,000</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>0</td>
<td>5,000</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Net short-term capital gain</td>
<td>0</td>
<td></td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Net short-term capital loss</td>
<td>0</td>
<td></td>
<td>0%</td>
<td>0</td>
</tr>
</tbody>
</table>

Computation of Net Income

| Ordinary net income       | $6,000 |
| Short-term capital gains  | $7,000 |
| Long-term capital gains   | $6,000 |
| **Total**                | $19,000 |

Deduct: Short-term capital loss:

1. Excised during taxable year (as per section 117 (d) (2)) $5,000

2. Net short-term capital losses carry-over (not in excess of net income for 1938, $6,000) but not to exceed excess of short-term capital gains over short-term capital losses for 1939 $900

Net income: $1,000

Example (2): For the taxable year 1939 the same individual as in Example (1) has ordinary net income (net income exclusive of gains or losses from sales or exchanges of capital assets) of $6,000; short-term capital gains of $5,000; and short-term capital losses of $6,000. His long-term capital gains and losses to be taken into account in computing net income consist of the following:

| Long-term capital gains | $7,000 |
| Long-term capital losses | 11,000 |
| **Total**              | 18,000 |

Net income: $1,000

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733

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this purpose the amount of such net long-term capital gain, plus (2) 30 percent of the net long-term capital gain.

In the case of a net long-term capital loss of a taxpayer otherwise computed under sections 11 and 12, if and only if such tax is greater than the tax imposed by sections 11 and 12. This alternative tax is the excess of (1) a tax, at the rates provided by sections 11 and 12, on the net income of the taxpayer excluding from the computation of such net income, the amount of the net long-term capital loss over (2) 30 percent of the net long-term capital loss.

The following examples will illustrate the practical operation of the provisions of this article:

Example (1): Suppose that A, an individual, has for the calendar year 1938 an ordinary net income of $100,000, none of which consists of interest on the obligations of the United States or its instrumentalities. He is entitled to a personal exemption of $2,500 and to no credit for depreciation of the net income. The net income of A is $97,500. He realizes in that year a gain of $45,000 on a capital asset held for 19 months and a gain of $40,000 on a capital asset held for 26 months. Suppose, also, that A has no losses from the sale or exchange of capital assets. Since the alternative tax is less than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $47,513. The tax is computed as follows:

**Tax Under Sections 11 and 12**

<table>
<thead>
<tr>
<th>Ordinary net income</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less credit for personal exemption</td>
<td>2,500</td>
</tr>
<tr>
<td>Surtax net income</td>
<td>$147,500</td>
</tr>
<tr>
<td>Less earned income credit (10 percent of $97,500)</td>
<td>9,750</td>
</tr>
<tr>
<td>Income subject to normal tax</td>
<td>$147,200</td>
</tr>
<tr>
<td>Normal tax (4 percent of $147,200)</td>
<td>5,888</td>
</tr>
<tr>
<td>Surtax on $147,500</td>
<td>67,550</td>
</tr>
<tr>
<td>Total tax</td>
<td>$63,438</td>
</tr>
</tbody>
</table>

**Alternative Tax Under Section 117 (c) (1)**

<table>
<thead>
<tr>
<th>Net income</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary net income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less credit for personal exemption</td>
<td>2,500</td>
</tr>
<tr>
<td>Surtax net income</td>
<td>$97,500</td>
</tr>
<tr>
<td>Less earned income credit (10 percent of $97,500)</td>
<td>9,750</td>
</tr>
<tr>
<td>Income subject to normal tax</td>
<td>$87,750</td>
</tr>
<tr>
<td>Normal tax (4 percent of $87,750)</td>
<td>3,510</td>
</tr>
<tr>
<td>Surtax on $97,500</td>
<td>63,438</td>
</tr>
<tr>
<td>Partial tax under sections 11 and 12 on $300,000</td>
<td>95,388</td>
</tr>
<tr>
<td>Total alternative tax</td>
<td>$47,513</td>
</tr>
</tbody>
</table>

Example (2): Suppose that in example (1) the facts with respect to net income and credits are the same, except that the taxpayer has for the calendar year 1938 an ordinary net income of $200,000, and that he realizes in that year a loss of $100,000 on a capital asset held for 5 years, and that he has no gains from the sale or exchange of capital assets. Since the alternative tax is greater than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $80,388. The tax is computed as follows:

**Tax Under Sections 11 and 12**

<table>
<thead>
<tr>
<th>Ordinary net income</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less credit for personal exemption</td>
<td>2,500</td>
</tr>
<tr>
<td>Surtax net income</td>
<td>$197,500</td>
</tr>
<tr>
<td>Less earned income credit (10 percent of $97,500)</td>
<td>9,750</td>
</tr>
<tr>
<td>Income subject to normal tax</td>
<td>$197,750</td>
</tr>
<tr>
<td>Normal tax (4 percent of $197,750)</td>
<td>7,888</td>
</tr>
<tr>
<td>Surtax on $197,500</td>
<td>67,550</td>
</tr>
<tr>
<td>Partial tax under sections 11 and 12 on $300,000</td>
<td>95,388</td>
</tr>
<tr>
<td>Total tax</td>
<td>$63,438</td>
</tr>
</tbody>
</table>

**Alternative Tax Under Section 117 (c) (2)**

<table>
<thead>
<tr>
<th>Net income (excluding from the computation $50,000, the amount of the net long-term capital loss)</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less credit for personal exemption</td>
<td>2,500</td>
</tr>
<tr>
<td>Surtax net income</td>
<td>$147,500</td>
</tr>
<tr>
<td>Less earned income credit (10 percent of $97,500)</td>
<td>9,750</td>
</tr>
<tr>
<td>Income subject to normal tax</td>
<td>$147,200</td>
</tr>
<tr>
<td>Normal tax (4 percent of $147,200)</td>
<td>5,888</td>
</tr>
<tr>
<td>Surtax on $147,500</td>
<td>67,550</td>
</tr>
<tr>
<td>Partial tax under sections 11 and 12 on $300,000</td>
<td>95,388</td>
</tr>
<tr>
<td>Total tax</td>
<td>$63,438</td>
</tr>
</tbody>
</table>

AAX. 117-4. Determination of period for which capital assets are held.—Under section 117 (c) if property is acquired in certain transactions described in sections 112, 113, 116, and 371 (c), the period for which such property is considered to have been held by the taxpayer is not to be computed from the date of acquisition by the donor, but from the date such property was acquired by the taxpayer but from a prior date. For instance: In the case of stock or securities the loss from the sale or other disposition of which was not deductible was held must be included in the period for which the stock or securities the loss from the sale or other disposition of which was not deductible was held must be included in the period for which the stock or securities were held by the taxpayer. If the period for which the taxpayer has held stock issued to him as a non-taxable stock dividend shall be determined as though the stock dividend were the stock in respect of which the dividend was issued.

AAX. 117-5. Application of section 117 in case of husband and wife.—Under the general rule with respect to deductions in a joint return of husband and wife (see article 61-1), a deduction which is not allowable in computing the net income of one spouse making a separate return is not allowable in a joint return made by both spouses. Hence, the limitation under section 117 (d) (2), relating to the allowance of short-term capital losses, is, in the case of one spouse, to be computed without regard to the short-term capital gains and losses of the other spouse, regardless of whether a joint return or separate returns are filed.

(b) Long-term capital gains and losses.—In the case of a joint return, the tax under sections 11 and 12 is imposed upon the aggregate net income of both spouses, after giving effect to the deductions which each spouse would be entitled to in a separate return (see article 61-1). The allowance of a long-term capital loss is not subject to a limitation such as that contained in section 117 (d) (2). Accordingly, in the case of a joint return, the long-term capital losses of either spouse may be deducted from the aggregate income in computing the tax imposed under sections 11 and 12. The alternative taxes computed under section 117 (c) are in lieu of the tax imposed by sections 11 and 12 and must be compared with the tax imposed by such sections to determine which tax is applicable. Therefore, in computing the alternative taxes under section 117 (c) in the case of a joint return, the determination of the "net long-term capital gain" or the "net long-term capital loss" is to be made by first aggregating the long-term capital gains and the long-term capital losses, respectively, of both spouses.
mated 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 completed the sale by purchasing and delivering shares which he held for not more than 18 months, 100 percent of the recognized gain or loss would be taken into account. 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 delivery of property to cover the recognized gain or loss would be made. If the short sale is not deemed to be consummated until delivery, the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

CHAPTER XVIII
Loss From Wash Sales

Sec. 118. Loss from wash sales of stock or securities.—(a) In the case of any loss claimed to have been sustained from any sale or other disposition of 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. However, this prohibition does not apply (1) in the case of a taxpayer who acquired the stock or other disposition of stock or securities is made in connection with the taxpayer’s trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities the provisions of this article shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities is determined and 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 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 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 shares of stock or securities sold or otherwise disposed of which is not deductible shall be determined under rules and regulations prescribed by the Commissioner.

Art. 118-1. Losses from wash sales of stock or securities.—(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this article as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer who acquired the stock or other disposition of stock or securities is made in connection with the taxpayer’s trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities the provisions of this article shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities is determined and 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 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 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 shares of stock or securities sold or otherwise disposed of which is not deductible shall be determined under rules and regulations prescribed by the Commissioner.

Example (1): A, whose taxable year is the calendar year, on December 1, 1937, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1937, purchased 100 additional shares for $9,000. On January 2, 1938, he sold the 100 shares purchased on December 1, 1937, for $9,000. Because of the provisions of section 118 no less from the sale is allowable as a deduction.

Example (2): A, whose taxable year is the calendar year, on September 21, 1937, purchased 100 shares of the common stock of the M Company for $5,000.

Example (3): A, whose taxable year is the calendar year, on November 15, 1936, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1938, for $4,000.
On each of the four days from February 15, 1936, to February 18, 1938, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1938, but, since within the 61-day period a purchased not less than 100 shares of substantially identical stock, the loss is not deductible.

The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1938, and the 50 shares purchased on February 16, 1938. In determining the period for which the 50 shares purchased on February 15, 1938, and the 50 shares purchased on February 16, 1938, were held, there is to be included the period for which the 100 shares purchased on September 15, 1938, and sold on February 1, 1938, were held.

CHAPTER XIX

Income From Sources Within United States

Sec. 119. Income from sources within United States. Gross income from sources within 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 evidences of indebtedness of the United States or of the estate of residents therein, or of any officer or employee thereof, or of any officer or employee of a corporation, partnership, or foreign corporation, not engaged in business within the United States and not having an office or place of business therein, or

(2) Dividends.—The amount received as dividends—

(A) from a domestic corporation other than a corporation entitled to the benefits of section 361, and other than a corporation less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner that less than 20 per centum of whose gross income
cated or apportioned to sources within the United States.

Art. 119-2. Interest.—There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations which are entitled to the benefits of section 251, and other than one entitled to the benefits of section 261, all interest received, as the case may be, from the United States, any 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) that have been carried on within the United States, and not having an office or place of business therein;

(b) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that the payor or domestic corporation has been paid the close of the taxable year of such corporation preceding the declaration of such dividends, for such part of such period as it has been in existence, was derived from sources within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for the purposes of section 131, relating to credits for taxes of foreign countries and possessions of the United States, dividends from a foreign corporation shall be treated as income from sources without the United States.

Dividends will be treated as income from sources within the United States (except for the purposes of section 131) unless the taxpayer submits sufficient data to establish to the satisfaction of the Commissioner that they should be excluded from gross income under (a) or (b) of this article. (See also section 116 (f).)

Art. 119-4. Compensation for labor or personal services.—Except as provided in section 119 (a) (3), gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of performance. If a specific amount of 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 or an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

Art. 119-5. Rentals and royalties.—Gross income from sources within the United States includes rentals or royalties from property situated in the United States or from any interest in such property, including rentals or royalties for the use 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 or property, whether tangible or intangible, within the United States, is from sources within the United States.

Art. 119-6. Sale of real property.—Gross income from sources within the United States includes gain, computed under the provisions of sections 111-113, derived from the sale or other disposition of real property located in the United States. Gain from the sale of capital gains and losses, see section 117.

Art. 119-7. Income from sources without the United States.—Gross income from sources without the United States includes:

(1) Interest other than that specified in section 119 (a) (1), as being derived from sources within the United States;

(2) Dividends other than those derived from sources within the United States as provided in section 119 (a) (2);

(3) Compensation for labor or personal services performed without the United States for the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see article 119-4;

(4) Rentals or royalties derived from property without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property (see article 119-5); and

(5) Gain derived from the sale of real property located without the United States (see sections 111-113).

Art. 119-8. Sale of personal property.—Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold, except that income derived from the purchase of personal property within a possession of the United States.
and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. A possession of the United States constitutes a "country," within the meaning of this article, separate and distinct from the United States. Hence income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within a possession of the United States. The word "sold" includes "exchanged." The "country" in which the "sold" or "exchanged" means the place where the property is marketed. This article does not apply to income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States or produced (in whole or in part) losses, or deductions without and sold within the United States. (See article 119-12.)

Art. 119-9. Deductions in general.—The deductions provided for in Title I shall be allowed to nonresident alien individuals and foreign corporations engaged in trade or business within the United States or having an office or place of business therein, and to citizens of the United States and domestic corporations entitled to the benefits of section 251, only if and to the extent provided in sections 213, 215, 232, 233, and 251.

Art. 119-10. Apportionment of deductions.—From items specified in articles 119-1 to 119-6 as being derived specifically from sources within the United States there shall be deducted expenses, losses, and other deductions properly apportioned or allocated there to 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 United States to the total gross income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States.

Art. 119-11. Other income from sources within the United States.—Items of gross income from sources within the United States 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, or other natural deposit, timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in article 119-12.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

Art. 119-12. Income from the sale of personal property derived from sources partly within and partly without the United States.—Items of gross income not allocated by articles 119-1 to 119-8 or 119-11 to sources within or without the United States shall (unless unmistakably from a source within or a source without the United States) be treated as derived from sources partly within and partly without the United States. Such income derived from the sale of personal property may be divided into two classes: (A) income derived from sources partly within the United States and partly within a foreign country, and (B) income derived from sources partly within the United States and partly within a possession of the United States.

A. The portion of such income derived from sources partly within the United States and partly within a foreign country which is attributable to sources within the United States shall be determined according to the following rules and cases:

Personal property produced and sold.—Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a foreign country under circumstances named below. As used herein the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1-A.—Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling concerns and at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return.

Case 2-A.—Where an independent factory or production price has not been
ance 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 the numerator of which consists of the value of the property within the United States, and the denominator of which consists of the value of the property both within the United States and within the foreign country. The remaining one-half 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 keeps and accounts 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. The portion attributable to sources within the United States shall be determined in accordance with 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 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 (in whole or in part) sold 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 following cases:

Case 1-B.—The net income shall first be computed by deducting from such gross income 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. 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 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 materials and supplies used 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 produced within the possession of the United States or in the United States and its sale within the foreign country, the portion attributable to sources within the United States and partly from sources within the United States under one of the cases below.

Case 3-B.—Same as case 3-A.
and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Case II-B.—Same as case 3-A.

Art. 119–13. Transportation service.—A foreign corporation carrying on the business of transportation, service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(1) The gross income from sources within the United States derived from such an enterprise, comprising such a portion of the total gross revenues therefrom as (a) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable ratable part of the property used in its transportation business while within the United States bears to (b) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business, revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with the part of the voyage taking such a portion of the total gross revenues therefrom as (a) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable ratable part of the property used in its transportation business while within the United States bears to (b) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business, revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

(2) In computing net income from sources within the United States there shall be allowed as deductions from the gross income as determined in accordance with paragraph (1), (a) the expenses of the transportation business carried on within the United States as determined under paragraph (1), and (b) the expenses determined in accordance with paragraphs (3) and (4).

(3) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in paragraph (1); but for the purpose of computing net income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest (deductible under section 23 (b)), and (b) all income, war-profits, and excess-profits taxes (deductible under section 23 (c) and (d)), paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service.

(4) If a foreign corporation subject to this article is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses (including taxes) properly apportioned or allocated to such other business should be excluded both from the deductions and from the apportionment process prescribed in paragraph (1); but, for the purpose of determining net income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income.

(5) Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer subject to this article, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process prescribed in paragraphs (1)–(4), the income derived from sources within the United States.

Art. 119–14. Telegraph and cable service.—A foreign corporation carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within the United States and partly from sources without the United States.

(1) Gross income.—The gross income from sources within the United States derived from such services shall be deter-
or trust company organized under the laws of any State, Territory, possession of the United States, or of the Canal Zone, of any other banking corporation 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, income taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States, and of the entire net income of the United States, determined as provided in section 322.

(h) Dividends.-In the case of a corporation, the amount (a) of any income, war profits, and excess-profits taxes paid or accrued during the taxable year; (b) 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; (c) 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, determined as provided in section 322.

(i) Certain preferred stock.-The amount of the credit shall be paid or accrued during the taxable year to any foreign country or to any possession of the United States, and of the United States, determined as provided in section 322.

(j) Certain Aliens.-In the case of any alien resident of the United States, the amount of any such tax paid or accrued during the taxable year to any foreign country or to any possession of the United States, determined as provided in section 322.

(k) Certain other corporations.-In the case of any corporation, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(l) Certain partnerships.-In the case of any partnership, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(m) Certain trusts.-In the case of any trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(n) Certain estates and trusts.-In the case of any estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(o) Certain partnerships and trusts.-In the case of any partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(p) Certain foreign corporations.-In the case of any foreign corporation, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(q) Certain foreign partnerships and trusts.-In the case of any foreign partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(r) Certain foreign estates and trusts.-In the case of any foreign estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(s) Certain foreign partnerships and trusts.-In the case of any foreign partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(t) Certain foreign estates and trusts.-In the case of any foreign estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(u) Certain foreign partnerships and trusts.-In the case of any foreign partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(v) Certain foreign estates and trusts.-In the case of any foreign estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(w) Certain foreign partnerships and trusts.-In the case of any foreign partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(x) Certain foreign estates and trusts.-In the case of any foreign estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(y) Certain foreign partnerships and trusts.-In the case of any foreign partnership or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.

(z) Certain foreign estates and trusts.-In the case of any foreign estate or trust, the amount of any income, war profits, and excess-profits taxes paid or accrued during the taxable year, or to any foreign country or to any possession of the United States, determined as provided in section 322.
percentage of its gross income from sources within a possession of the United States; (2) organized under the China Trade Act, 1922, and entitled to the credit provided for in section 262.

**Art. 131-1. Analysis of credit for taxes.**—If the taxpayer signifies in his return his desire to claim a credit for taxes, the basis of such credit, in the case of a citizen of the United States, whether resident or nonresident, and in the case of a domestic corporation, is as follows: (a) The amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (b) an individual's proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

In the case of an alien resident of the United States who signifies in his return his desire to claim a credit for taxes, the basis of the credit is as follows: (a) The amount of any such taxes paid or accrued during the taxable year to any possession of the United States; (b) the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and (c) his proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to any possession of the United States, or to any foreign country, as the case may be, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.

If a taxpayer signifies in his return his desire to claim a credit for taxes, such action will be considered to apply to income, war-profits, and excess-profits taxes paid to the United States, or, in imposing such taxes, by exempting from taxation the incomes received from sources without the United States and from each foreign country shall, upon the request of the Commissioner, be furnished by the taxpayer.

In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond, or a sworn copy. In case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of section 322.

**Art. 131-5. Countries which do or do not satisfy the similar credit requirement.**—A country satisfies the similar credit requirement of section 131 (a) (3), as to income tax paid to such country, either by allowing to citizens of the United States residing in such country a credit for the amount of income taxes paid to the United States, or, in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such country. A country does not satisfy the similar credit requirement of section 131 (a) (3), as to income taxes paid to such country, 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 resident in such country a credit for taxes paid by such citizen to another foreign country, no credit is allowed to such resident alien for taxes paid by him to such other foreign country.

**Art. 131-6. When credit 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 (b) (1) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under this section or under 131 (a) 222 (c) or 223 (c) of the Revenue Act of 1924 or 1926, or under section 131 (d) of the Revenue Act of 1928, 1932, 1934, 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.

Art. 131-7. Domestic corporation owning a majority of the stock of foreign corporation.—In the case of a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes not only the income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States by such domestic corporation, but also income, war-profits, and excess-profits taxes 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 determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued by such controlled foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. The amount of taxes deemed to have been paid is limited, however, to an amount which shall in no case exceed the same proportion of the tax against which the credit for foreign taxes is taken, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. If dividends are received from more than one controlled foreign corporation, the limitation is to be computed separately for the dividends received from each controlled foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to the taxes deemed to have been paid as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by a controlled foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

Art. 131-8. Limitations on credit for foreign taxes.—The amount of the income and profits taxes paid or accrued (including the taxes which, in accordance with the provisions of section 131 (f), are deemed to have been paid) during the taxable year to each foreign country or possession of the United States, from which such dividends were paid, must be deducted from the amount of such dividends paid in arriving at the amount of such dividends which are included in the net income of the domestic corporation for purposes of credit for foreign taxes. Section 131 (b) (1) so as not to exceed that proportion of the tax against which credit is taken which the taxpayer's net income from sources within such country or possession bears to his entire net income for the same taxable year, is the tentative credit for foreign taxes, and the amount of such tentative credit 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 within such country or possession bears to his entire net income for the same taxable year, is the amount allowable as a credit against the income tax under Title I for income and profits taxes paid or accrued to foreign countries or possessions of the United States.

The operation of the limitations on the credit for foreign taxes may be illustrated by the following examples:

Example (1) : In 1933, A, a citizen of the United States, had a net income for services rendered within the United States amounting to $80,000 and a net income from sources within Great Britain of $25,000. He is entitled to a personal exemption of $1,000. The credit for foreign taxes allowable to A in his return for the calendar year 1938 is $6,494.67, computed as follows:

<table>
<thead>
<tr>
<th>Income from sources within the United States</th>
<th>Income from sources within Great Britain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25,000.00</td>
<td>$3,000.00</td>
</tr>
<tr>
<td>Total net income</td>
<td>78,000.00</td>
</tr>
</tbody>
</table>

British income and profits taxes: $6,494.67

Example (2): If, in example (1), above, A had a net income from sources within Great Britain of $18,000 and a net income from sources within Canada of $10,000 and the income and profits taxes paid or accrued to Great Britain and Canada were $4,000 and $1,200 respectively, the credit for foreign taxes allowable to A would be $5,096.80, computed as follows:

<table>
<thead>
<tr>
<th>Income from sources within the United States</th>
<th>Income from sources within Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>$18,000.00</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Total net income</td>
<td>28,000.00</td>
</tr>
</tbody>
</table>

British income and profits taxes: $1,099.00

Example (3): If, in example (1), above, A had a net income from sources within Great Britain of $18,000 and a net income from sources within Canada of $10,000, and a dividend of $5,000 was received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation, the French corporation paid to such 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 determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued by such controlled foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits.

The amount of taxes deemed to have been paid is limited, however, to an amount which shall in no case exceed the same proportion of the tax against which the credit for foreign taxes is taken, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. If dividends are received from more than one controlled foreign corporation, the limitation is to be computed separately for the dividends received from each controlled foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to the taxes deemed to have been paid as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by a controlled foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

No. 98—7
assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) Computation and payment of tax.—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and paid in accordance with the regulations under subsection (b), (or, in case such regulations are not prescribed prior to the date on which such return is made, the regulations prescribed under section 141 (b) of the Revenue Act of 1930 insofar as not inconsistent with this Act), prescribed prior to the date on which such return is made.

(d) Definition of “affiliated group.”—As used in this section an “affiliated group” means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 95 per cent of the stock of each of the corporations (except the component part of a street or sub) is owned directly by one or more of the other corporations;

(2) Each of the corporations is either (A) a corporation whose principal business is that of a railroad, the business of receiving consolidated earnings, or (B) a corporation the assets of which consist principally of stock in such corporations as is railroad business, or (C) a corporation with which such railroad business is operated as such by another common carrier by rail, the business of receiving rents furnished to railroad, the business of receiving rents from such railroad property shall be considered as the business of a common carrier by rail.

As used in this subsection (except in paragraph (3)) the term “stock” does not include voting stock which is limited and preferred as to dividends.

(e) Foreign Corporations.—A foreign corporation shall not be deemed to be affiliated with any other corporation within the meaning of this section.

(f) China Trade Act Corporations.—A corporation organized under the China Trade Act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of this section.

(g) Corporations deriving income from possessions of United States.—For the purposes of this section a corporation entitled to the benefits of section 251, by reason of receiving a large percentage of its income from possessions of the United States, shall be treated as a foreign corporation.

(h) Subsidiary formed to comply with foreign law.—In the case of a 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 election of the domestic corporation, be treated for the purposes of this title as a domestic corporation.

(i) Extension of statute of limitations.—If a notice under section 272 (a) in respect of a taxable year is served to a corporation organized under the laws of a contiguous foreign country and maintained solely for the purposes of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the election of the Domestic Corporation, be treated for the purposes of this title as a domestic corporation.

(j) Definitions of terms.—In the case of corporations with which such

<table>
<thead>
<tr>
<th>Country</th>
<th>Income and profits taxes paid or accrued</th>
<th>Tentative credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Great Britain</td>
<td>$750,000.00</td>
<td>4,394.55</td>
</tr>
<tr>
<td>Canada</td>
<td>$1,500.00</td>
<td>4,394.55</td>
</tr>
<tr>
<td>Brazil</td>
<td>$4,394.55</td>
<td>2,029.70</td>
</tr>
<tr>
<td>Mexico</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>$12,400.00</td>
<td>5,659.40</td>
</tr>
<tr>
<td>France</td>
<td>$2,029.70</td>
<td>1,800.00</td>
</tr>
<tr>
<td>Total income and profits taxes paid or accrued</td>
<td>$13,400.00</td>
<td>$10,253.94</td>
</tr>
<tr>
<td>Tentative credit</td>
<td>$1,500.00</td>
<td>$10,253.94</td>
</tr>
<tr>
<td>Sum of Tentative Credits</td>
<td>$15,903.94</td>
<td>$10,253.94</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Income and profits taxes paid or accrued</th>
<th>Tentative credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Great Britain</td>
<td>$4,394.55</td>
<td>1,250.00</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td>1,250.00</td>
</tr>
<tr>
<td>Brazil</td>
<td></td>
<td>1,250.00</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td>1,250.00</td>
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<tr>
<td>Total income and profits taxes paid or accrued</td>
<td>$9,500.00</td>
<td>$3,000.00</td>
</tr>
<tr>
<td>Tentative credit</td>
<td>$1,250.00</td>
<td>$3,000.00</td>
</tr>
</tbody>
</table>

CHART XXII

Returns and Payment of Tax

Supplement D—Returns and Payment of Tax [Supplementary to Subtitle B, Part V]

Sec. 141. Consolidated returns of railroad corporations.—(a) Privilege to file consolidated returns.—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) (or, in case such regulations are not prescribed prior to the date on which such return is made, the regulations prescribed under section 141 (b) of the Revenue Act of 1930 insofar as not inconsistent with this Act), prescribed prior to the date on which such return is made.

(b) Regulations.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in accordance with this section. The regulations prescribed prior to the date on which such return is made shall include the income of any affiliated group of corporations making a consolidated return and of each corporation in the group; both during and after the period of affiliation, may be determined, computed,
corporation made a consolidated return for such taxable year.

(j) Receivership cases.—If the common parent corporation or any member of an affiliated group making a consolidated return would, if filing a separate return, be entitled to the benefits of section 141 or the entire capital stock of the member of such group at the time that the aggregate of its stock in such member is the owner directly of at least 95 percent of the stock (as defined in section 141 (d)) of another corporation. A corporation becomes a member of an affiliated group at the time that one or more members of the group become the owners directly of at least 95 percent of its stock. A corporation ceases to be a member of an affiliated group at the time that the aggregate of its stock owned directly by the members of the group becomes less than 95 percent.

Anr. 141-1. Consolidated returns of affiliated corporations for taxable years beginning after December 31, 1937.—The regulations prescribed under section 141 (b) have been promulgated as Regulations 190 and are applicable to the making, after the promulgation of such regulations, of consolidated returns by affiliated corporations for taxable years beginning after December 31, 1937, and to the determination, computation, adjustment, and apportionment of income and deductions and tax liabilities under consolidated returns for such years. For the definition of taxable year, see section 48.

Anr. 141-2. Form of and changes in affiliated group.—An affiliated group of corporations, within the meaning of section 141, is formed at the time that the common parent corporation becomes the owner directly of at least 95 percent of the stock (as defined by section 141 (d)) of another corporation. A corporation becomes a member of an affiliated group at the time that one or more members of the group become the owners directly of at least 95 percent of its stock. A corporation ceases to be a member of an affiliated group at the time that the aggregate of its stock owned directly by the members of the group becomes less than 95 percent.

Anr. 141-3. 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 of foreign corporations (exclusive of directors' qualifying shares) of a corporation described in section 141 (d) and organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the requirements of the operation of such foreign corporation, the corporation may, at the option of the domestic corporation, be treated for taxable years beginning after December 31, 1937, as a domestic corporation. The option of the domestic corporation shall be irrevocable. The corporation shall have the same status for the purpose of computing the tax as the domestic corporation which it is a member for each year for which such corporation makes or is required to make a consolidated return.

Sect. 142. Fiduciary returns.—(a) Requirement of return.—A fiduciary shall make a return of income—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife.

(2) Every individual having a net income for the taxable year of $5,000 or over, if married living with husband or wife.

(3) Every individual having a net income of $5,000 or over, regardless of the amount of the net income, and

(4) Every estate or trust which the gross income of which for the taxable year is $1,000 or over.

(b) Joint fiduciaries.—Under such regulations as the Commissioner may prescribe, two or more joint fiduciaries may file a joint return for a taxable year and may be treated as a single fiduciary and filed in the office of the collector of the district, where such fiduciary resides, shall be subject to the provisions of the Act, and shall be entitled to the benefits of such subsection, regardless of the amount of the net income.

(c) Low applicable to fiduciaries.—Any fiduciary required to make a return under this section may elect to comply with the provisions of law which apply to fiduciaries.

Anr. 142-1. Fiduciary returns.—Every fiduciary, or at least one of joint fiduciaries, must make a return of income—

(1) For the individual whose income is in his charge, if the gross income of such individual is $5,000 or over, or if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife for any part of the taxable year; or if such individual is married and was living with husband or wife for any part of the taxable year but not at the close of the taxable year and his gross income for the taxable year is $5,000 or over, or his net income is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family); or if such individual is married and was living with husband or wife for any part of the taxable year and the aggregate gross income of both husband and wife is $5,000 or over, or the aggregate net income of both husband and wife is $2,500 or over; or if such individual is married and was living with husband or wife for any part of the taxable year but not during the entire taxable year and the aggregate gross income of both husband and wife is $5,000 or over, or the aggregate net income of both husband and wife is $2,500 or over, or his net income is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family), or

(b) For the estate for which he acts or for any trust for which he acts, if the net income of such estate or trust is $1,000 or over, as computed under section 162, and for the trust for which he acts if the net income of such trust is $5,000 or over, as computed under section 162, or if the gross income of the estate or trust is $5,000 or over, regardless of the amount of the net income, or if any beneficiary of such estate or trust is a nonresident alien.

The return in case (a) shall be on Form 1040 or 1040 A. In case (b) a return is required on Form 1041. A copy of the will or trust instrument sworn to by the fiduciary as a true and complete copy in cases in which the gross income of the estate or trust is $5,000 or over, must be filed with the return. A 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 allocable to the beneficiaries, or the grantor, respectively. If, however, a copy of the will
or trust instrument, or statement relating to the provisions of the will or trust instrument, has once been filed, it need not again be filed if the fiduciary return contains a statement showing when and where it was filed. If the trust instrument is amended in any way after such copy has been filed, a copy of the amendment, together with a statement by the fiduciary, indicating the effect, if any, in his opinion, of such amendment on the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively, must be filed with the return for the taxable year in which the amendment was made. See article 142–5 for returns in cases where any beneficiary is a nonresident alien. If the net income of a decedent from the beginning of the taxable year to the date of his death was equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (2) (computed without regard to his status as a member of a family), or if his gross income for the same period was $5,000 or over, the executor or administrator shall make a return for such decedent. (See article 25–7.)

For information returns required to be made by fiduciaries under section 147, see article 147–1.

As to further duties and liabilities, of fiduciaries, see section 312.

**Art. 142–2. Return by guardian or committee.**—A fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, having a net income equal to, or in excess of, the credit allowed such person by section 25 (b) (1) and (3) (computed without regard to the status of the minor or insane person as head of a family), or having a gross income of $5,000 or over, must make a return for such person on Form 1040 or 1040 A and pay the tax, unless in the case of a minor the minor himself makes a return or causes it to be made.

For the purpose of determining the liability of a fiduciary to render a return under the provisions of the preceding paragraph in cases where the minor or the incompetent is married and was living with husband or wife at the close of the taxable year, it is the aggregate gross income or the aggregate net income of both husband and wife which is controlling. (See article 51–1.)

**Art. 142–3. Returns where two trusts.**—In the case of two or more trusts, the income of which is taxable to the beneficiaries, which were created by the same person and for which the same trustee acts, the trustee shall make a single return on Form 1041 for all such trusts, notwithstanding that they may arise from different instruments. If, however, one person acts as trustee for trusts created by different persons for the benefit of the same beneficiary, he shall make a return on Form 1041 for each trust separately.

**Art. 142–4. Return by receiver.**—A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on Form 1040 or 1040 A. When acting for a corporation a receiver is not treated as a fiduciary, and in such case the return shall be made in the name of 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 are not fiduciaries. (See also sections 147 and 148 (a).)

**Art. 142–5. Return for nonresident alien beneficiary.**—(a) United States business or office.—If a citizen or resident fiduciary has the distribution of the income of an estate or trust to any beneficiary of which is a nonresident alien engaged in trade or business within the United States or having an office or place of business therein at any time within the taxable year, the fiduciary shall make a return on Form 1040B for each such nonresident alien and pay any tax shown thereon to be due. (See sections 145 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 shall be obtained by the fiduciary 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 make a return on 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. The fiduciary shall make a return on Form 1043 of the tax at 10 percent on the entire amount of the income payable to the beneficiary, except that in the case of a beneficiary, resident of Canada, the rate shall be 15 percent. In addition to such return or returns, the fiduciary shall make a return on Form 1041 for the estate or trust, irrespective of the number of beneficiaries.

**Art. 142–6. Time for filing return upon death, or termination of trust.**—After his appointment and qualification, an executor or administrator may immediately file a return for the decedent without waiting for the close of the taxable year. Upon the completion of the administration of an estate and final accounting, an executor or administrator may immediately file a return of income for the estate for the taxable year in which the administration was closed. Similarly, upon the termination of a trust, the trustee may immediately make a return without waiting for the close of the taxable year. Any income return required to be filed for a decedent covering the taxable year during which the decedent dies, or for the year in which an estate is closed or a trust terminated, is due on the 15th day of the third month following the close of the taxable year during which the decedent dies, or the estate is closed, or the trust is terminated, which date shall also be the due date for payment of the tax or the first installment thereof if payment is made under the provisions of section 56 (b). The payment of the tax before the end of the taxable year under such circumstances does not relieve the taxpayer from liability for any additional tax.
found to be due upon income of the taxable year. (See sections 57 and 272.)

The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. Consequently the only return required to be filed by a domiciliary representative is on Form 1041, which shall be filled 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 domiciliary representative, and the declarant's claim against such income, including any amount of income properly paid or credited by the domiciliary representative to any legatee, heir, or other beneficiary. If the domiciliary 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 domiciliary representative is required to render the return otherwise required of the domiciliary representative.

Sec. 143. Withholding of tax at source.—(a) Exemptions.—(1) Exemption of tax from payment and collection. 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 thereon by this title upon the obligor, or to reimburse the obligee for any portion of the tax, or to pay the interest thereon for any portion of the tax, the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States or of any state or political subdivision thereof, any tax or interest thereon, whether such interest is payable annually or at shorter or longer periods, if payable to an individual, a partnership, or a foreign corporation, not engaged in trade or business within the United States, and not having any office or place of business therein and composed in whole or in part of nonresident alien interests, except (1) such portion of the interest as may be received as indemnification for personal services of nonresident alien individuals who enter and earn the United States, (2) more than 5 percent 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), or (3) dividends paid by a foreign corporation unless such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (b) more than 5 percent 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), or (c) an amount of tax so withheld from the interest paid in connection with the sale of bonds between interest dates.

(b) Withholding in general.—Withholding of a tax of 10 percent is required in the case of fixed or determinable annual or periodic income paid to a nonresident alien individual (even though such individual is engaged in trade or business within the United States or has an office or place of business therein) or to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having any office or place of business therein, (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant, and issued before January 1, 1934, (3) of any tax imposed by the provisions of section 222 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent, and (4) of (of this article), (3) dividends paid by a foreign corporation unless (a) such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (b) more than 5 percent 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), or (c) an amount of tax so withheld from the interest paid in connection with the sale of bonds between interest dates.

(c) Payment of tax._—The tax must be withheld at the source from the gross amount of any distribution made by a corporation, other than a nonresident alien individual or corporation, which may be distributable in stock or stock rights. In event of partial or complete liquidation, without regard to any claim that all or any portion of such distribution is not taxable, appropriate adjustments, if any, will be made upon the filing of claims for refund.

The tax must be withheld at the source for any interest paid by the withholding agent in the case of a resident alien individual who files a written certification with the withholding agent that the withholding of tax is necessary, in the case of a nonresident alien individual, who files a signed notice in writing claiming the benefit of the credits provided in section 871, (3) of any tax imposed by the provisions of section 222 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent, and (4) of (of this article), (3) dividends paid by a foreign corporation unless (a) such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (b) more than 5 percent 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), or (c) an amount of tax so withheld from the interest paid in connection with the sale of bonds between interest dates.

(d) Withholding in general.—Withholding of a tax of 10 percent is required in the case of fixed or determinable annual or periodic income paid to a nonresident alien individual (even though such individual is engaged in trade or business within the United States or has an office or place of business therein) or to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having any office or place of business therein, (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant, and issued before January 1, 1934, (3) of any tax imposed by the provisions of section 222 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent, and (4) of (of this article), (3) dividends paid by a foreign corporation unless (a) such corporation is engaged in trade or business within the United States or has an office or place of business therein, and (b) more than 5 percent 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), or (c) an amount of tax so withheld from the interest paid in connection with the sale of bonds between interest dates.
is unknown to the withholding agent, except where such interest represents income from sources within the United States.

For withholding in the case of income paid to nonresident foreign corporations, see article 144-1.

Resident or domestic fiduciaries are required to withhold 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, regardless of whether the beneficiaries are exempt from income tax.

A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act in its behalf under the withholding provisions of the Act, is required to file notice of such appointment with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., giving the name and address of the agent.

If, in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, or corporation, must deduct and withhold such taxes as would be required to be withheld by the assignor had no such sale or transfer been made.

For determining income from sources within the United States, see section 119.

As to who are nonresident alien individuals, see articles 211-2 and 901-8. For classification of foreign corporations, see articles 231-1 and 901-6. As to what partnerships are deemed to be nonresident partnerships, see article 901-8.

For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see articles 143-3 and 263-4.

(d) 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 purposes 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 acts as selling agent of the obligor outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

In order that the date of issue of bonds, mortgages, or deeds of trust, or other similar obligations of corporations, containing a tax-free covenant may be readily determined by the owner, for the purpose of preparing the ownership certificates required under articles 143-1 to 143-9 the “issuing” or debtor corporation shall indicate, by an appropriate notation, the date of issue or use the phrase, “Issued on or after January 1, 1934,” on each such obligation or in a statement accompanying the delivery of such obligation.

In cases where on or after January 1, 1954, the maturity date of bonds or other obligations of a corporation having an issue of a tax-free covenant 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 scope 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 residents or nonresidents, withholding at the rate of 10 percent is required, except that if the liability assumed by the obligor in connection with such a covenant does not exceed 2 percent of the interest, withholding is required at the rate of 10 percent in the case of a nonresident alien, or a nonresident partnership, or a 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 tax-free covenant bonds issued before January 1, 1934, paid to an individual or fiduciary who is a citizen or other person, 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 a nonresident foreign corporation, see article 144-1.

Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, but the original trust deeds were executed prior to January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued prior to January 1, 1934, are subject to the provisions of section 143 (a), provided appropriate authority existed for the modification of the trust deeds in this manner.

The authority must have been contained in the original trust deeds or actually secured from the bondholders.

In the case of corporate bonds or other obligations containing a tax-free covenant, issued before January 1, 1934, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax may nevertheless be claimed by the bondholder as a credit against the total amount of income tax due in accordance with section 143 (d). The tax withheld at the source upon tax-free covenant, bond interest included in the income of an estate or trust and taxable to the beneficiaries thereof (including the grantor of a trust subject to section 166 or 167) is allowable, pro rata, as a credit against (1) the tax required to be withheld by the fiduciary from the income of nonresident alien beneficiaries and (2) against the total tax computed in the returns of the beneficiaries required to make returns. In the case, however, of corporate bonds or other obligations containing a tax-free covenant, and issued before January 1, 1934, the corporation paying for some one else, pursuant to its agreement, a State tax or any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

Art. 143-2. Fixed or determinable annual or periodical income.—Only fixed or determinable annual or periodical income is subject to withholding. The Act specifically includes in such income, interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income are included, as, for instance, royalties.

Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. That the length of
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 110 and are distributed to:

(1) A nonresident alien other than a resident of China at the time of such distribution;

(2) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in China); or

(3) A nonresident foreign corporation (other than a corporation resident in China).

The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals, shall not be subject to deduction and withholding of income tax at the source, provided he is a resident of Canada or Mexico.

(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 should contain the address of the business and a statement that he is a citizen of France residing in France. The letter from such corporation shall contain the address of its office or place of business and a statement that it is a corporation organized under the laws of the Republic of France, and shall be signed by an officer of the corporation giving his official title. The letter of notification or a copy thereof should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Sorting Section, Washington, D.C.

A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year is subject to the tax imposed by section 211 (a) on gross income and is not subject to any personal exemption or credit for dependents. Although a nonresident alien individual who is engaged in trade or business within the United States or has an office or place of business therein is entitled to the personal exemption of $1,000 (and a credit for dependents if he is a resident of Canada or Mexico), he is subject to the normal tax and the surtax imposed by sections 11 and 12 of the Act by reason of the provisions of section 211 (b) and the benefit of the personal exemption and credit for dependents may not be received by filing a claim therefor with the withholding agent.

A coloration of interest certificates for bond interest. In accordance with the provisions of section 147 (b), citizens and resident individuals and fiduciaries, resident partnerships and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates for each issue of such obligations regardless of the amount of the coupons.

In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

In all cases where the owner of bonds, mortgages, or deeds of trust, or other similar obligations of a corporation is a nonresident alien, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or where the owner is unknown, an ownership certificate on Form 119 (a) (1) (B), or of a nonresident foreign corporation.

The ownership certificate shall show the name and address of the debtor corporation, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment.

Ownership certificates need not be filed in the case of interest payments on obligations of a State, Territory, or political subdivision thereof, or the District of Columbia; or obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States; or the obligations of the United States or its possessions. (See section 22 (b) (d).) 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 of the bonds is known to the first bank to which the coupons are pre-
sented 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 coupon was received by the payee, and alleging that the owner of the bonds is unknown to the payee. Such statement shall be forwarded to the Commissioner with the monthly return on Form 1012. The bank shall require the payee to prepare a certificate on Form 1001, crossing out "owner" and inserting "payee" and entering the amount of the interest on line 3, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank.

Ownership certificates are required in connection with interest payments on registered bonds as in the case of coupon bonds, except that if ownership certificates are not furnished by the owner of such bonds, ownership certificates must be prepared by the withholding agent.

Art. 143-5. Form of certificate for citizens or residents.—For the purpose of article 143-4, Form 1000 shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 shall be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation.

Art. 143-6. Form of certificate for nonresident aliens, nonresident foreign corporations, and unknown owners.—For the purpose of article 143-4, Form 1001 shall be used in preparing ownership certificates (a) of nonresident aliens, (b) of resident partnerships composed in whole or in part of nonresident aliens, (c) of nonresident foreign corporations, and (d) where the owner is unknown.

Art. 143-7. Return and payment of tax withheld.—Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld from interest on bonds or other obligations of corporations. This return should be filed with the collector for the district in which the withholding agent is located. The withholding agent shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the monthly return. Such of the forms as report interest from which 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 to show the name and address of a fiscal or paying agent in the United States (see article 143-5). Forms 1012 and 1013 should be likewise modified.

Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return 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 an annual report of the tax withheld on all registered bonds as in the case of coupon bonds. There shall be returned, on Form 1042B, for the calendar year 1938 and each subsequent calendar year, in addition to the withholding return on Form 1042, with respect to the items of income from which a tax of only 5 percent was withheld, from Canadian addresses. There shall be reported, on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns on Form 1012, including items of interest where the liability for withholding is only 2 percent.

In the case of corporations whose addresses are within Canada, only the fixed or determinable annual or periodical income from sources within the United States consisting of dividends should be reported.

In every case the tax withheld must be paid to the collector on or before June 15 of the following year. For penalties and additions to the tax attaching upon failure to make such returns or such payments, see articles 145 and 291.

If a debtor corporation has designated a person to act for it as withholding agent, and does not withhold any tax from the income nor receive 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, the income allocable to the income so taxed to such creditor by reason of such person's appointment as withholding agent.

If a person is subject to the taxes imposed by section 11, 12, 13, or 14 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to 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.

Art. 143-8. Ownership certificates in the case of fiduciaries and joint owners.—If fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. The ownership certificate should show the name of the estate or trust, in addition to the name and address of the fiduciary. If bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners.

Art. 143-9. Return of income from which tax was withheld.—The entire amount of the income from which the tax was withheld shall be included in the gross income in the return required to be made by the recipient of the income without deduction for such payment of the tax but any tax so withheld shall be credited against the total income tax as computed in the taxpayer's return. (See, however, article 142-3, relating to the income tax paid by the recipient of the income or by the withholding agent it shall not be re-collected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for the failure to return or pay the tax where no fraud or purpose to evade payment is involved.

Tax withheld at the source upon fixed or determinable annual or periodical income paid to nonresident alien fiduciaries is deemed to have been paid by the persons ultimately liable for the tax upon such income. Accordingly, if a person is subject to the taxes imposed by section 11, 12, 13, or 14 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to 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.
FEDERAL REGISTER, Saturday, February 11, 1939

vested in that section: Provided, That in the case of interest in subsection (c) that section (relating to tax-free covenant bonds) the deduction and withholding shall be at the rate specified in such subsection.

Art. 144-1. Withholding in the case of nonresident foreign corporations.—A tax of 15 percent is required to be withheld in the case of fixed or determinable annual or periodical income paid to a nonresident foreign corporation except:

1. Income from sources within the United States. In the case of interest in subsection (c) that section (relating to tax-free covenant bonds) the deduction and withholding shall be at the rate specified in such subsection.

2. Income on interest paid to a nonresident foreign corporation except:

(a) Income on interest paid to a nonresident foreign corporation except:

(b) Income on interest paid to a nonresident foreign corporation except:

(c) Income on interest paid to a nonresident foreign corporation except:

3. Dividends paid to a nonresident foreign corporation are:

4. Dividends paid to a nonresident foreign corporation are:

5. Dividends paid to a nonresident foreign corporation are:

6. Other income from sources within the United States, as defined in section 145 cannot be assessed but are enforceable only by suit or prosecution. For limitations on prosecutions, see the Act of June 25, 1930, as amended by section 705 of the Revenue Act of 1932 (paragraph 61 of the Appendix to these regulations). The willful failure of a taxpayer to give information required in his return as to advice or assistance rendered in the preparation of the return, and the willful failure of the person preparing a return for another to make such statement as required with reference thereto, make such per-
sons subject to the penalties imposed by section 146 (a). The privilege against in-ermination 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 or capital gain from any taxpayer's income was made through crime.

Sec. 146. Closing by commissioner of taxable
able year.—(a) Tax in jeopardy.—(1) De-
ung a person from the collection of the Corporation finds that he has procured from the collector or agent in charge a certificate that he has complied with the provisions of the income, war-profits, and excess-profits tax laws.

(1) Addition to tax.—If a taxpayer violates or attempts to violate this section there shall, in addition to all other penalties, be added to the return for the period the amount of the tax or deficiency in the tax, together with interest at the rate of 6 per centum from the time the tax became due.

Art. 146-1. Termination of the taxable period by Commissioner.—(a) Section 146 provides that in the case of a taxpayer who designs by immediate departure from the United States or other-

(b) Same—Exemption from section.—If a person who is a citizen of the United States or who is a resident or nonresident, who intends to depart from the United States for the taxable year 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 shall appear before the collector or internal revenue agent in charge for the district in which he resides and satisfy all income tax obligations. Any such certificate received or to be received, determined as nearly as may be, to up and including the date of his intended departure. Upon payment of such obligations, or upon furnishing of such security as may be required, by the Collector, 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 certificate and any property therefrom, or to conceal himself or part from the United States or to remove his

(c) Same—Exemption from section.—If a person who is a citizen of the United States or who is a resident or nonresident, who intends to depart from the United States for the taxable year will be required to make return or returns and pay the tax or taxes for the taxable year then last past or the taxable year then current unless such pro-

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not exceeding double the amount of tax for his taxable year current at the time of his income tax return 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 years together with any penalty and interest that may accrue thereon, such bond to be executed by a surety or sureties approved by the Commissioner. In lieu of such a surety bond, the taxpayer may furnish as security a penal bond (Form 1133), bonded and signed by the Commissioner, secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax or taxes in respect of which the bond is furnished. A form of a "certificate of compliance" is made a part of Form 1040D. Bonds complying with the provisions of this article, if properly executed and with adequate surety, are approved, and may be accepted in the name of the Commissioner, by the collector or internal revenue agent in charge by signing the Form 1133 as follows:


(name of the Commissioner, under such regulations and such instructions hereinafter provided for).

Commissioner of Internal Revenue.

By ____________________________

(Internal Revenue Agent in Charge.)

A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds. If the surety on the bond is an individual or individuals such bond shall not be accepted until an investigation is made as to the financial and other responsibility of such surety or sureties and such investigation shows that the collection of the tax is amply secured by the bond.

Sun. 147. Information at source.—(a) Payments of $1,000 or more.—All persons, in whatever capacity or under whatever title or description (except real estate agents [but the agent must report payments made to real estate agents (other than payments made in the United States or for services rendered in the United States)] and persons engaged in the occupation of a fire insurer, or other companies issuing fire insurance policies, or other companies issuing property, fire, or marine insurance policies), receiving wages, salaries, commissions, or any other compensation from any person, company, or corporation, in the United States, or for services rendered in the United States, shall be required to include in gross income the amount of all payments received from any one person, company, or corporation in any one calendar year of $1,000 or more, and such payments made to the landlord if the amount paid during the year was $1,000 or more, notwithstanding that the amount paid did not exceed $1,000. If any such payment is made in respect of travel expenses, the return should be filed with the approved form prescribed by the Commissioner of Internal Revenue, showing the number of returns filed, except that the return with respect to distributions made to beneficiaries of a trust or estate, or to persons upon whom payment is to be made, shall be furnished upon demand of the person paying the income.

(b) Obligations of United States.—The provisions of this section shall not apply to the payment of interest on obligations of the United States:

Ann. 147-1. Return of information as to payments of $1,000.—All persons making payment to another person of fixed or determinable income of $1,000 or more in any calendar year must render a return thereof to the Commissioner for such year on or before February 15 of the following year, except as specified in articles 147-3 to 147-5. Such return shall be made in each case on Form 1099, accompanied by Form 1099 paid by the United States to persons in its service (civil, military, or naval) as an allowance for traveling expenses, including an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, and any other allowance or reimbursement for traveling expenses.

Ann. 147-3. Cases where no return of information required.—Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099:

(a) Payments of interest on obligations of the United States;

(b) Payments by a broker to his customer;

(c) Payments of any type made to corporations;

(d) Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges;

(e) Payments of rent paid by real estate agents (but the agent must report payments made to real estate agents (other than payments made in the United States or for services rendered in the United States]) to residents of the United States; and

(f) Payments made to alien employees serving in foreign countries or payments representing earned income for services performed over a year are made, whether or not the amount paid during the year was $1,000 or more.

(g) Payments of rent made to real estate agents (but the agent must report payments made to real estate agents (other than payments made in the United States or for services rendered in the United States]) to nonresident citizens entitled to the benefits of section 116 (a); and

(h) Payments of salaries, or other compensation for personal services aggregating less than $2,500 made to a married individual (citizen or resident);

(i) Payments of commissions made by fire insurance companies, or other companies insuring property, to general agents, except when specifically directed by the Commissioner to be filed;

(j) Payments of income upon which income tax has been withheld at the source and reported on Forms 1012, 1013, or 1042; and

(k) Amounts paid by the United States to persons in its service (civil, military, or naval) as an allowance for traveling expenses, including an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, and any other allowance or reimbursement 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 to which the return relates, the payee will be considered a single person for the purpose of filing a return of information on Form 1099 with respect to payments of salaries or other compensation for personal services.

Art. 147-4. Return of information as to interest on corporate bonds.—In the case of payments to other than citizens or residents of the United States, the term "interest" means any income from obligations of corporations, the ownership certificates of which, when duly filed, shall constitute and be treated as returns of information. (See article 143–5.)

Art. 147-5. Return of information as to payments to other than citizens or residents.—In the case of payments of fixed or determinable annual or periodical income to nonresident aliens (individual or fiduciary), to nonresident partnerships composed in whole or in part of nonresident aliens, to the account of the person presenting the foreign item until the Act for information at the source is received, the name and address of the actual owner or payee shall be furnished upon demand of the individual, corporation, or partnership accepting 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 file Form 1097 to disclose the name and address of the actual owner or payee. Form 1097 should be filed with the Commissioner of Internal Revenue, Section 148, D. C., not later than February 15 of the succeeding year. Unless such a disclosure is made, the record owner will be held liable for any tax based upon such dividends. (See Article 148–1.)

The filings of Form 1097 are not required (a) if the record owner is required to file a fiduciary return, 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 10 percent tax has been withheld at the source prior to receipt of the dividends by the record owner. (See article 143–1.)

Art. 147-6. Foreign items.—The term "foreign items," as used in these regulations, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States, or any item of dividends upon the stock of such corporation.

Art. 147-7. Return of information as to foreign items.—In the case of foreign items, an information return on Form 1099 is required to be filed by the bank or collecting agent accepting the items for collection, if the foreign item is paid to a citizen or resident of the United States (individual or fiduciary), or a partnership any member any of which is a citizen or resident, and if the amount of the foreign items paid in any taxable year to an individual, partnership, or a fiduciary is $1,000 or more. Such forms accompanied by Form 1096 should be forwarded to the Commissioner of Internal Revenue, Section 148, 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 deposit. (See articles 147–7, 148–1, 153–1, 154–1.)

Art. 147-8. Information as to actual owner.—When the person receiving a payment falling within the provisions of the Act for information at the source is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the individual, corporation, or partnership accepting 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 file Form 1097 to disclose the name and address of the actual owner or payee. Form 1097 should be filed with the Commissioner of Internal Revenue, Section 148, D. C., not later than February 15 of the succeeding year. Unless such a disclosure is made, the record owner will be held liable for any tax based upon such dividends. (See Article 148–1.)

The filings of Form 1097 are not required (a) if the record owner is required to file a fiduciary return, 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 10 percent tax has been withheld at the source prior to receipt of the dividends by the record owner. (See article 143–1.)

Sec. 148. Information by corporations.—(a) Dividend payments.—Every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him.

(b) Profits declared as dividends.—Every corporation shall, when required by the Commissioner, furnish him a statement of such facts as will enable him to determine the portion of the earnings of profits of the corporation (including gains, profits, and income not taxable for the period covered by such a statement) as the Commissioner may specify, which have been distributed or ordered to be distributed, regardless of the shareholders during such taxable years as the Commissioner may specify.

(c) Accumulated earnings and profits.—When requested by the Commissioner, or any collector thereof, the corporation shall forward to the Commissioner, or any collector, a correct statement of its accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be paid to them.

(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 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 of its stock paid or credited by a building and loan association to its holders of that class of stock if the amounts paid are dividends within the meaning of section 115 (a). The sum received upon withdrawal from a building and loan association in excess of...
the amounts paid in on account of membership fees and stock subscriptions, consisting of accumulated profits, constitutes a dividend within the meaning of section 115 (a). As to when a stock dividend is taxable as a dividend see section 115 (f).

(b) In case of distributions which are made from a depletion or depreciation reserve, or which for any other reason are deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation will first fill in the whole or any part of its capital stock, then file the returns of the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than February 1 of the following year. Upon receipt of this information the Commissioner will determine and advise the corporation whether any portion of such distribution is subject to tax. The corporation after receiving this letter will then properly prepare for each shareholder a Form 1099, which shall be forwarded with Form 1096 to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than 30 days after such letter is received.

In any case in which it is impossible to file the return within the time prescribed in this article, the corporation may, upon a showing of such fact, obtain a reasonable extension of time for filing the return. The request for the extension of time must be forwarded to the Commissioner of Internal Revenue, Practice and Procedure Division, Washington, D. C., on or before the date prescribed for filing the return.

Art. 148-2. Return of information respecting contemplated corporation by liquidation.—(a) Making and filing of returns.—Within 30 days after the adoption on or after May 28, 1938, of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock, the organization shall file with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, a correct return on Form 966, made under oath or affirmation and containing the information required by paragraph (b) of this article and by such form. A like return shall be filed by the corporation in the case of any amendment of, or supplement to, a resolution or plan for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock adopted on, before, or after May 28, 1938, if such amendment or supplement was adopted on or after May 28, 1938. A return must be filed under section 148 (d) in respect of a liquidation of the corporation or the liquidation of the whole or any part of its capital stock adopted on, before, or after May 28, 1938, if such amendment or supplement was adopted on or after May 28, 1938. A return must be filed under section 148 (d) in respect of a liquidation of the corporation or the liquidation of the whole or any part of its capital stock adopted on, before, or after May 28, 1938. A return must be filed under section 148 (d) in respect of a liquidation of the corporation or the liquidation of the whole or any part of its capital stock adopted on, before, or after May 28, 1938.

(b) Contents of return.—(1) General.—There shall be attached to and made a part of the return required by section 148 (d) and paragraph (a) of this article a certified copy of the resolution or plan, together with any amendments thereof or supplements thereto, and such return shall in addition contain the following information:

(i) The name and address of the corporation;
(ii) The place and date of incorporation;
(iii) The date of the adoption of the resolution or plan and the dates of any amendments thereof or supplements thereto;
(iv) The collection district in which the last income tax return of the corporation was filed and the taxable year covered thereby.

(2) Liquidation in December, 1938.—In the event that the corporation is a domestic corporation and the plan of liquidation (adopted after May 28, 1938) provides for a distribution in complete cancellation or redemption of all the shares of the corporation, and for the transfer of all the property of the corporation under the liquidation entirely within the month of December, 1938, such return shall, in addition to the information required by paragraph (b) (1) of this article, contain the following information:

(i) A statement showing the number of shares of each class of stock outstanding on the date of the adoption of the plan of liquidation, together with a description of the voting power of each such class;
(ii) A list of all the shareholders owning stock on the date of the adoption of the plan of liquidation, together with the number of shares of each class of stock owned by each shareholder, the certificate numbers thereof, the total number of votes to which entitled on the adoption of the plan of liquidation; and a statement of all changes in ownership of stock by corporate shareholders between April 9, 1938, and the date of the adoption of the plan of liquidation, and a statement of all changes in ownership of stock by corporate shareholders between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive.

(3) Returns in respect of amendments or supplements.—If a return in respect of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock has already been filed pursuant to section 148 (d), a return in respect of any amendment thereof or supplement thereto will be deemed sufficient if it gives the date such prior return was filed and contains a certified copy of such amendment or supplement and all other information required by this article and by Form 966 which was not given in such prior return. If no return was filed relative to the resolution or plan which is being amended or supplemented, the return relative to the amendment thereof or supplement thereto shall contain a duly certified copy of the resolution or plan which is being amended or supplemented, together with any amendments thereof or supplements thereto, and all other information required by this article and by Form 966.

Art. 148-3. Return of information respecting distributions in liquidation.—If the distribution is one in respect of which information is required to be furnished pursuant to article 112 (b) (6), (112 (c) 6), or 317-10, every corporation making any distribution in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099, giving all the information required by such forms and by these regulations. A separate Form 1099L must be prepared in duplicate for each shareholder to whom such distribution was made, showing the 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 and a statement of its fair market value at the time of the distribution.

Such duplicate forms, accompanied by a letter of transmittal on Form 1096 showing the number of Forms 1096L filed therewith, shall be filed with the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before February 15 of the year following the calendar year in which such distribution was made. If the distribution is in complete liquidation of a domestic corporation pursuant to a plan of liquidation adopted after May 28, 1938, in accordance with which all the capital stock of the corporation is canceled or redeemed and the transfer of all the property under the liquidation occurs in the month of December, 1938, the return on Form 1096 shall show (1) the amount of earnings and profits of the corporation accumulated after February 28, 1913, determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938, (2) the ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation, and (3) the date and circumstances of the acquisition by the corporation of any stock or securities distributed to shareholders in the liquidation.
ject to taxation under Title I which during any taxable year beginning on or after January 1, 1938, has paid to any officer, employee, or other agent of the corporation salary, commission, bonus, or other compensation for personal services rendered, in an aggregate amount in excess of $7,500 (in whatever form paid), shall, in respect of each such taxable year, make and file, in duplicate, Schedule 22-A, as a part of its income tax return, in accordance with the instructions contained in the prescribed return. Such schedule shall contain the following information:

1. Name of officer or employee,
2. Amount of salary paid,
3. Amount of commission paid,
4. Amount of bonus paid,
5. Amount of other compensation paid, and
6. Total compensation paid.

The term "paid" as used in this article means "paid or accrued" or "paid or incurred" which shall be construed according to the method of accounting upon the basis of which the net income of the corporation is computed.

Upon receipt of the returns by the collector, the schedules will be detached and forwarded by the collector to the Commissioner of Internal Revenue, Sorting Section, D. C.

ART. 149-1. Return of information by brokers.—Every person doing business as a broker shall, when required by the Commissioner, render a correct return 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.

Every person or organization acting as broker or other agent in stock, bond, or commodity transactions (including handling orders or deposits or custodian accounts) is hereby directed to make an annual return of information on Form 1100 for each customer, depositary, or account for whom or which the total amount of either sales of securities, sales of commodities, purchases of securities, or purchases of commodities, for the customer, or the total market value of the securities exchanged for the customer or account.

The making of Form 1100 by banks and trust companies may be confined to cases involving sales and exchanges for customers aggregating $25,000 or more during the year, and the dollar totals may be omitted from the Form 1100. It is to be understood, however, that such a form shall be made for each case involving sales and exchanges aggregating $25,000 or more during each year.

Banks and trust companies will not be required to file Form 110 covering purchases, sales, or exchanges made by them when acting for themselves or as executor, administrator, trustee, or in any other fiduciary capacity (not including custodian or safe-keeping accounts as fiduciary), or for other banks, trust companies, brokers, or other financial institutions doing business in the United States. Banks and trust companies will not be required to file returns covering purchases and sales where they do not actually give the orders for the purchases and sales.

Brokers and other agents handling purchases and sales of commodities for customers may report on Form 1100 for each year either the total profit or loss of each customer on all such transactions, when $500 or more, in lieu of the profit or loss is reported on Form 1100 by the customer. Banks and trust companies will not be required to file returns covering purchases and sales where they do not actually give the orders for the purchases and sales.

Brokers and other agents handling purchases and sales of securities for customers may report on Form 1100 for each year either the total profit or loss of each customer on all such transactions, when $500 or more, in lieu of the profit or loss is reported on Form 1100 by the customer. If the profit or loss is reported on Form 1100, the broker or agent shall prepare for each customer whenever the amount of the total profit or loss of the customer from all such transactions is $500 or more for the calendar year, and the form should be noted accordingly.

Persons or organizations having domestic correspondents will not report on Form 1100 for such domestic correspondents inasmuch as each correspondent will report for his or her individual customers.

Form 1100 is printed on white paper and a duplicate thereof is printed on pink paper. In each case where the account is guaranteed or others have power to make withdrawals of cash, securities, or commodities from the account, a duplicate of the form as prepared on white paper shall be made on the pink form for each name and address, other than the customer, required to be shown on Form 1100.

Form 1100A is provided for use as a letter of transmittal and affidavit to accompany Form 1100. The Forms 1100A for each year accompanied by Form 1100, properly filled out and executed, shall be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., not later than February 15, following the close of the calendar year, and will be distributed through the collectors of internal revenue for the various collection districts.

Returns made by individuals must be sworn to by the individual or his duly authorized agent. Returns made by corporations, partnerships, and other organizations must be signed and sworn to by the officer or member of the organization.

Sec. 150. Collection of foreign items.—All persons undertaking as a matter of business or for profit the collection of foreign pay- ments, Interest or dividends, or of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations as the Commissioner may require, and any person failing to comply with such regulations shall be guilty of a misdemeanor and shall be fined not more than $5,000 or imprisoned for not more than one year, or both.

ART. 150-1. License to collect foreign items.—Banks or agents collecting foreign items, as defined in article 147-6, and required by article 147-7 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors.

The license is based on Form 1010. Any person holding a license under the Revenue Act of 1936 or any prior Act will not be required to renew such license.

Sec. 151. Foreign personal holding companies.--For information returns by officers, directors, and large shareholders, see sections 338, 339, and 346.

CHAPTER XXIII

Estates and Trusts

Supplement E—Estates and Trusts

Sec. 101. Imposition of tax.—(a) Application of tax.—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including:

1. Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income in trust which is to be distributed current to the beneficiaries, or distributed as to the beneficiaries, in accordance with the terms of the will or trust;
2. Income which is to be distributed current to the beneficiaries, or distributed as to the beneficiaries, in accordance with the terms of the will or trust;
3. Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income in trust which is to be distributed current to the beneficiaries, or distributed as to the beneficiaries, in accordance with the terms of the will or trust;
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 16B (relating to revocable trusts) and section 16B (relating to income benevolent). For return made by fiduciary, see section 16B.

ART. 161-1. Imposition of the tax.—(a) Scope.—Supplement E prescribes that the taxes imposed upon individuals by Title I shall be applicable to the income of estates or of any kind of property held in trust. The rate of tax, the statu-
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 thereof, the meaning of the word "corpus," 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. That is, the provisions of sections 161 and 167 deal with certain trusts which are excluded from the scope of sections 161, 162, and 163. Other trusts, not specified in sections 161 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 articles 165–1 and article 167–1. See section 165 as to the exemption of employees' trusts.

(b) Taxability of the income.—The fiduciary is required to make and file the return and pay the tax on the net income of the estate or trust except as otherwise provided in sections 165, 166, and 167, and articles 165–1 and 167–1. In determining whether there is any net income subject to the tax, and to what extent, consideration is to be given to the additional deductions authorized in section 162.

Sec. 162. Net income.—The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is to be held or distributed as the court may direct, but only such portion as is authorized by section 23 (o) to be included in computing the net income of the beneficiaries whether distributed to them or not. Any 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.

(b) In the case of income received by ca-
tate of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the absence 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.

Ann. 162-1. Income of estates and trusts.—In ascertaining the tax liability, income thereby included in the estate of a deceased person or of a trust there are also deductible (either in lieu of, or in addition to, the deductions referred to in the preceding paragraph of this article) the following:

1. Any part of the gross income of the estate or trust or for its taxable year which is to be distributed currently by the fiduciary to a beneficiary, whether or not such income is actually distributed.

2. Any income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to a beneficiary, whether or not such income is actually distributed.

3. Any income of the estate of a deceased person for its taxable year which is properly paid or credited during such year to a legatee or heir, and any income either of such an estate or of a trust for its taxable year which is similarly paid or credited during that year to a legatee, heir, or beneficiary (see paragraph (2) of this article).

In all such cases the tax is payable by the fiduciary, except the tax upon the income which is taxable to the grantor of the trust.

Any amount described in paragraph (2) or (3) above as being deductible from the gross income of the estate or trust shall be included in computing the net income of the legatees, heirs, or beneficiaries, whether distributed to them or not.

Any income of an estate or trust for its taxable year which during that year may be used, pursuant to the terms of the will or trust instrument, in the discharge or satisfaction, in whole or in part, of a legal obligation of any person is, to the extent so used, taxable to such person as though directly distributed to him as a beneficiary. (See, also, article 167–1.)

The income of an estate of a deceased person, as dealt with in the Act, is there-

in described as remaining in substance that of the grantor 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 the order of the court or not. No taxable income is realized from the passage of property to the executor or administra-
tor 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 in respect of such gains shall be allowed as credits against net income. If real estate is sold by the devisee or heir thereof, whether before or after settlement of the estate, he is taxable individually on any profit derived.

The tax upon the net income of the estate or trust shall be paid by the fiduciary (see section 161 (b)). If the tax has been properly paid on the net income of an estate or trust, the net income on which the tax is so paid is not, in the hands of the distributee thereof (the legatee or the beneficiary), taxable as income to him.

Liability for the payment of the tax attaches upon 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 618 of the Revenue Act of 1934 (paragraph 48 of the Appendix to these regulations).

Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, or distributees. Any remaining portion of such interest will be allowed as a credit for the purpose of the computation of the tax due and unpaid to the extent of the amount due and unpaid to the estate or trust, but one personal exemption, no matter from how many trusts he may receive income. (See section 25.)

Sec. 163. Credits against net income.—(a) Credits of estate or trust.—(1) For the purpose of the normal tax and the surtax an estate shall be allowed the same personal exemption as provided for a single person under section 25 (b) (1), and a trust shall be allowed (in lieu of the personal exemption under section 25 (b) (2)) a credit of $100 against net income.

(b) Credit for interest to estate or trust.—If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, the estate or trust shall be allowed the credits provided in section 25 (a), in respect of interest upon certain obligations of the United States.

(c) Credit for interest to beneficiary.—If any part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, he is allowed for the purpose of the normal tax, in addition to his individual credits, the proportionate share of the interest upon obligations of the United States and instrumentalities of the United States which is exempt from normal tax only and is required to be included in computing the taxable income of the estate or trust, the proportionate share of such interest which such 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 such interest and is required to be included in computing the taxable income of the estate or trust as required by section 25 (a).

(d) 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 the taxable income of the estate or trust as required by section 25 (a).

(e) Taxable years beginning prior to January 1, 1939.—A trust forming part of a plan defined in paragraph (a) is exempt for taxable years beginning prior to January 1, 1939, if: (1) contributions are made to the trust by such employer, as meaning employees or both; and (2) such contributions are made for the purpose of distributing to such employees both the earnings and principal of the fund accumulated by the trust; and (3) the fund is accumulated by the trust in accordance with the plan of which the trust is a part.

(f) Taxable years beginning after December 31, 1938.—A trust forming part of a plan defined in paragraph (a) is exempt for taxable years beginning after December 31, 1938, if all three tests designated in paragraph (b) as (1), (2), and (3) are met; and (2) such contributions are made for the purpose of distributing to such employees both the earnings and principal of the fund accumulated by the trust for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees.

(d) Impossibility of diversion.—As used in section 165 (a) (2), the phrase "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the non-exempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. It is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, but except as stated

section (a) shall not apply to a taxable year beginning before January 1, 1939.
in paragraph (c), it must be impossible for trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees. The diversion of substantial amounts of trust funds from one group of employees to another group of employees is not for the "exclusive" benefit of employees even though both groups were covered by the trust, if the employer (or other non-employee) receives substantial indirect benefit thereby, as for example, through greater loyalty from the favored group, or through the shifting of expected pension benefits to a younger group and the postponement of part of the employer's contributions to a later date. As used in section 165 (a) (2), the phrase "purpose other than for the exclusive benefit of his employees" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees covered by the trust.

(e) Meaning of "liabilities."—The report of the Committee on Finance states that the intent and purpose in section 165 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees under the trust" is to permit the employer to recover only such balance in the trust at its termination as is "due to erroneous actuarial computations during the previous life of the trust." An "erroneous actuarial computation" means a mistake of an actuarial character reasonably made by a careful person skilled in calculating the amount necessary to satisfy pecuniary obligations depending on the average length of life of a group of individuals, and of such a type that the employer may recover the right to recover an amount remaining in the trust because of the mistake without conflicting with the purpose for which section 165 (a) (2) was enacted. For example, if a trust created to supply pensions of $25 a month for 10,000 employees for the remainder of their lives after age 60 has been used to supply such pensions to 500 employees, an amount remaining in the trust for this reason is not due to such a mistake, but to a change in plan; while if $25 a month after age 60 is paid to the 10,000 employees during their lives, but their average duration of life proves less than might reasonably have been expected, an amount remaining in the trust for this reason is due to an "erroneous actuarial computation." Employers might recover more than amounts resulting from such errors if the term "liabilities" included only such obligations to employees as are legally fixed and certain. Hence, the term was used in the Act in its broad common meaning to include both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be from such employees (or other non-employees), to recover other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all such fixed and contingent obligations, and the trust instrument must contain a definite affirmative provision to that effect, whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

(g) Proof of claim.—Every trust claiming exemption must prove its right thereto by filing with the collector: (1) an affidavit showing its character, purpose, activities, sources and disposition of corpus and income, and every fact which may affect its status for exemption, (2) copies of the trust instrument and of the employer's plan, showing all amendments, and (3) the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the trust. The financial statement must be filed each year, but the documents mentioned in (1) and (2) need not be filed after the first year except when necessary to show changes occurring since the last filing.

Sec. 166. Revocable trusts.—Where at any time the title to any part of the corpus of the trust is in the grantor, either alone or in connection with any person not having a substantial adverse interest in the corpus, the income of which constitutes the trust corpus will vest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, 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's income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership of the corpus. In determining whether the grantor is in substance the owner of the corpus, the Act has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustee 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 admin-
intered 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 duration 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 in trust in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

For example, a grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and subsequent to that time, but in the absence of such an extension the title is once more to revert 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 description (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 revert in him 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 a 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, or, if the corpus is to be regarded as in substance the owner of the corpus, then vested in any person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) Income and deductions.—If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

Sec. 167. Income for benefit of grantor.—(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor;

(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;

(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, be accumulated for future distribution to the grantor;

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".

Any 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 is taxable to the grantor, not because the grantor has retained a certain interest in the corpus of the trust (as in section 166), but because of his retention of a certain interest in the income of the trust. This article deals with the taxation of such income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(b) Test of taxability to the grantor.—The test prescribed by the Act as to the sufficiency of the grantor's retained interest in the income resulting in the taxation of such income to the grantor, is whether he has failed to vest 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 more or less hypothetical vesting in any person within the meaning of section 167 if the income is paid to him or to another in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both;

(4) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the lapsing of an interval of time, or on the happening of a specified event, or otherwise;

(5) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as retaining in substance the owner of the trust income.

If, for example, trust income is applied in satisfaction of the grantor's legal ob-
lishment whether to pay a debt, to support dependents, to pay alimony, to furnish maintenance and support, or otherwise, such income is in all cases taxable to the grantor.

If the grantor strips himself permanently and definitely of every such interest relating to the trust, the trust fund may be considered as having been distributed to him, and thereupon the income of the grantor begins to be included in the gross income of the grantor. This income is in all cases taxable to the grantor. In computing his income, the test of taxation under this title, and the inclusion or exclusion of income, is the same as if the income were in the hands of the grantor.

The proportion of the net short-term capital gain or loss of the common trust fund which is subject to tax, shall be computed by subtracting the amount of the net short-term capital gain and adding the amount of the net short-term capital loss from the amount of the net long-term capital gain.

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term capital gain or loss computed for each such period. The proportionate shares of the participants in such items are then to be determined. The provisions of this paragraph may be illustrated by the following example:

Example: The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, D, E, F, and G for the first quarter; Trusts A, B, C, D, E, and F for the second quarter; and Trusts A, B, C, D, E, and F for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary net income and the short-term capital gain for the taxable year were as follows:

<table>
<thead>
<tr>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Fourth Quarter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary net income</td>
<td>$200</td>
<td>$300</td>
<td>$200</td>
<td>$400</td>
</tr>
<tr>
<td>Net short-term capital gain (loss)</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
</tr>
<tr>
<td>Gain on withdrawal</td>
<td>$250</td>
<td>$375</td>
<td>$250</td>
<td>$375</td>
</tr>
<tr>
<td>Loss on withdrawal</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
</tr>
<tr>
<td>Net income</td>
<td>$250</td>
<td>$375</td>
<td>$250</td>
<td>$375</td>
</tr>
</tbody>
</table>

Loss. The participants' shares of ordinary net income are as follows:

<table>
<thead>
<tr>
<th>Participant</th>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Fourth Quarter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>B</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>C</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>D</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>E</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>F</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>G</td>
<td>$50</td>
<td>$75</td>
<td>$50</td>
<td>$100</td>
<td>$275</td>
</tr>
<tr>
<td>Total</td>
<td>$200</td>
<td>$300</td>
<td>$200</td>
<td>$400</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

The participants' shares of net short-term capital gain or loss are as follows:

<table>
<thead>
<tr>
<th>Participant</th>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Fourth Quarter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$75</td>
<td>$125</td>
<td>$75</td>
<td>$125</td>
<td>$450</td>
</tr>
<tr>
<td>B</td>
<td>$75</td>
<td>$125</td>
<td>$75</td>
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</tr>
<tr>
<td>C</td>
<td>$75</td>
<td>$125</td>
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</tr>
<tr>
<td>D</td>
<td>$75</td>
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<tr>
<td>E</td>
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</tr>
<tr>
<td>G</td>
<td>$75</td>
<td>$125</td>
<td>$75</td>
<td>$125</td>
<td>$450</td>
</tr>
<tr>
<td>Total</td>
<td>$200</td>
<td>$300</td>
<td>$200</td>
<td>$400</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

(d) The provisions of sections 161, 162, 165, and 167 are applicable in determining the extent to which each participant's proportionate share of the income of the common trust fund is taxable to the participant, or to the beneficiaries or the grantor of the participant.

(e) If the taxable year of the common trust fund begins before January 1, 1938, the net capital gain or loss of such participant is required to be determined as of its gross income for its taxable year (even though beginning after December 31, 1937) within which or with which the taxable year of the fund ends, its proportionate share of the net income (computed to, according with the provisions of section 169 of the Revenue Act of 1936).

Ann. 169–3. Computation of common trust fund income.—The net income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(1) No deduction shall be allowed under section 23 (g) for charitable contributions.

(2) The short-term capital gains and losses of the common trust fund and its long-term capital gains and losses are required to be segregated and the computations made of the short-term capital gain or loss and the net long-term gain or loss, as the case may be.

A common trust fund is not allowed the benefit of the net short-term capital gain or loss carry-over provided by section 117 (a).

(3) The ordinary net income, that is, the excess of the gross income over the deductions, or the ordinary net loss, that is, the excess of the deductions over the gross income, shall be computed after excluding all items of either short-term or long-term capital gain or loss.

Ann. 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 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 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 the then participants in the common trust fund. (See paragraphs 27–50 of the Appendix to the regulations.) Such segregated investments shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising therefrom shall be divided among the participants for whose benefit the investment was segregated.

(b) Basis for gain or loss upon withdrawal.—The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the basis of the participating interest or portion thereof withdrawn (with proper adjustments as provided in section 113 (b) to the date of withdrawal) plus the additions prescribed in paragraph (c) of this article and minus the reductions prescribed in paragraph (d) of this article. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the money contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of subdivision (c) (7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, effective December 31, 1937. For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the custodian, shall 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 sections 166 or 167, shall be deemed to be the participant.

(c) Additions to basis.—As prescribed in paragraph (b) of this article, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the 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...
CHAPTER XXIV

Partnerships

Supplement F—Partnerships

Sec. 181. Partnership not taxable.—Indi-
vidual partners are not liable for taxes.
Such partners shall be liable for income tax
only in their
individual capacity.

Sec. 181-1. Partnerships.—Partnersh-
s as such are not subject to taxation under
the Act, but are required to make
returns of income. (See sections 187
and 188.) For definition of what
the term “partnership” includes, see section
501 (3).

Sec. 182. Tax of partner.

In computing the net income of each part-
ner, he shall include, whether or not dis-
tribution is made to him—

(a) As a part of his short-term capital
      gains or losses, his distributive share of
      the net short-term capital gain or loss of
      the partnership.
(b) As a part of his long-term capital
      gain or loss, his distributive share of
      the net long-term capital gain or loss of
      the partnership.
(c) His distributive share of the ordinary
      net income or the ordinary net loss of
      the partnership, computed as provided in
      section 185 (b).

Sec. 182-1. Distributive share of part-
ners.—(a) If the taxable year of the
partnership begins on or after January
1, 1938, each partner is required to include
in his return for his taxable year within
which or with which the taxable year of
the partnership ends, whether or not dis-
tributed:

(1) As a part of his short-term capital
      gains or losses, his distributive share of
      the net short-term capital gain or loss of
      the partnership.
(2) As a part of his long-term capital
      gain or loss, his distributive share of
      the net long-term capital gain or loss of
      the partnership.
(3) His distributive share of the ordinary
      net income or the ordinary net loss of
      the partnership, computed as provided in
      section 183 (b).

(b) If the taxable year of the partner-
ship begins before January 1, 1938, each
partner is required to include in his return
for his taxable year (even though beginning after December 31, 1937) within
which or with which the taxable year of
the partnership ends, his distributive share,
whether or not distributed, of the
net income or the ordinary net income of
the partnership as determined by the method provided in sections
183 and 188 of the Revenue Act of 1938. See section 188 of the Revenue
Act of 1938.

(c) If separate returns are made by
the husband and wife domiciled in a
community property State, and the hus-
band only pays or should be paying at Le.
the distributive share of the partner-
ship’s net short-term capital gain or loss,
net long-term capital gain or loss, or or-
dinary net income or ordinary net loss,
which is, or is derived from, any re-
port of the partnership, the distributive
share of the husband shall be reported
by the husband and the wife in equal
proportions. In the case of a partner-

ship closely related to other trades or
businesses, see section 49.

Sec. 183. Computation of partnership in-
come.—(a) General rule.—The net income
of the partnership shall be computed in the
same manner and on the same basis as
the income of an individual, except as provided in sections (b) and (c).

(b) Capital gains and losses.—There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed.

(c) Ordinary net income or loss.—After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

Sec. 187. Charitable contributions.—In comput-
ing the net income of the partnership the so-called “charitable contributions” 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 would have been required to be included in his taxable year, of the character which would be allowed to the partnership as a deduction under section 172 if that section had not been enacted.

Sec. 188-1. Computation of partnership in-
come.—The net income of the partner-
ship shall be computed in the same
manner and on the same basis as the net
income of an individual, except that:

(1) The partnership is required to
segregate its short-term capital gains
and losses and its long-term capital

gains and losses and to compute the net
short-term capital gain or loss and the
net long-term capital gain or loss, as
the case may be. A partnership is not
allowed the benefit of the net short-term

capital loss carry-over provided by sec-

(2) The partnership is further re-
quired, after excluding all items of either
short-term or long-term capital gain or
loss, to compute (a) an ordinary net in-
come which consists of the excess of the
gross income over the deductions, or
(b) an ordinary net loss which consists of the excess of the deductions over the gross
income. In the computation of its ordi-
nary 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 con-
sidered as having made payment, within
his taxable year, of his distributive por-
tion 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 partner-
ship as a deduction if section 172 (c) had
not been enacted. Payments made to a
partner for services rendered and for in-
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Sec. 184. Credits against net income.—The partner shall, for the purpose of the normal tax to a credit against his net income, in addition to the credits allowed to him under section 29, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership.

Art. 184-1. Credits allowed partners.—The credits against net income provided in so far as 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 29, of his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership. There shall be included in the return of the partnership a statement of the amounts of such interest and the proportionate share thereof of each partner.

Sec. 185. Earned income.—In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership.

Art. 185-1. Earned income credit of partners.—For the purpose of computing the earned income credit against net income (see section 25 (a) (3) and (4)), a member of a partnership is entitled to treat a proper part of his distributive share of the partnership net income as earned income. Such part cannot exceed a reasonable allowance as compensation for personal services actually rendered by the partner in connection with the partnership business. In the case of a partnership which is engaged in a trade or business in which capital is a material income-producing factor and in the trade or business of which the partner renders personal services which are material to the earning of the partnership income, the 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 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 of compensation (determined in accordance with the first paragraph of this article) of each partner's distributive share of the partnership net income which consists of earned income.

Example: A partnership composed of A, B, and C is engaged in the retail men's clothing business. Each partner is entitled to one-third of the net profits, after deduction of so-called salaries to partners. A devotes half 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 $9,000. C devotes none of his time to the business and receives no salary. The net profit of the partnership for the taxable year, computed without deduction for so-called salaries to members, is $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 $9,000, 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 $11,500 ($24,000 x 20 percent of his share 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 $9,000 ($24,000 x 20 percent of his share of net profits after deduction of $15,000 for salaries), B's earned income from the partnership is $1,800, which is 20 percent of his share of the net profits.

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 or members of the United States shall be allowed as a credit against the tax of the member of the partnership to the extent provided in section 131.

Art. 186-1. Partnership returns.—Every partnership shall make a return for each taxable year, stating the gross income and the deductions allowed under this title for the taxable year, computed without the deduction for the taxable year of the partnership of any salary (whether beginning on, before, or after January 1, 1938) ending within or after the taxable year of the partnership.

(b) Partnership year beginning in 1937.—If the taxable year of a partnership begins before January 1, 1938, the taxable year of a partner begins after December 31, 1937, the computation of the net income of the partnership, and the inclusion with respect to the partnership net income, in computing the net income of such partner, shall be made by the method provided in sections 182 and 183 of the Revenue Act of 1930 and provided in sections 182 and 183 of this Act.

CHAPTER XXV
Insurance Companies

Supplement G—Insurance Companies

Sec. 201. Tax on life insurance companies. Definition.—In this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance and the reserve funds required for the fulfillment of such contracts comprising more than 50 percent of its total reserve funds.

Art. 201 (a)–1. Life insurance companies: Definition.—The term "life insurance company" as used in Title I is defined in section 201 (a). In determining whether an insurance company is a "life insurance company" as defined in section 201 (a), no reserve shall be regarded as held for the fulfillment of an insurance contract unless it conforms to the definition of "reserve" contained in article 203 (a) (3)–1.

[Soc. 201. Tax on life insurance companies.]

(b) Imposition of tax.—(1) In general.—In computing the tax imposed by this section, there shall be levied, collected, and paid for each taxable year upon the special class net income of foreign life insurance companies a tax of 16½ per cent of the amount thereof.

(2) Special class net income of foreign life insurance companies.—In the case of a foreign life insurance company, the special class net income shall be an amount which bears the same ratio to the special class net income, computed without regard to this paragraph, as the reserve funds required by law and held by it at the end of the taxable year and on which business transacted within the United States is based, to the special class net income of all foreign life insurance companies at the end of the taxable year upon all business transacted.

Sec. 201. Tax on foreign life insurance companies.—Foreign life insurance companies not carrying on an insurance business within the United States, holding respect to property upon business transacted within the United States, shall not be taxable under this section but shall be taxable as other foreign corporations.

Art. 201 (b)–1. Life insurance companies: Rate of tax.—Life insurance companies are subject to the tax imposed by section 201 (b), in lieu of the tax imposed by sections 13 and 14. The rate is 16½ percent, and the tax is imposed
upon the special class net income as defined in section 14. The net income of life insurance companies differs from the net income of other corporations. Life insurance companies are entitled to the credits provided in section 26 (a) and (b) and are subject to the provisions of section 117 (capital gains and losses).

All provisions of the Act and of these regulations not inconsistent with the specific provisions of sections 201-203 are applicable to the assessment and collection of the tax imposed by section 201 (b), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

Art. 201 (b)-2. Foreign life insurance companies: Net income.—The special class net income of a foreign life insurance company taxed on an insurance business within the United States or holding reserve funds upon business transacted within the United States consists of that proportion of its net income from all sources, within and without the United States, computed under the provisions of sections 202 and 203 minus the credits provided in section 26 (a) and (b), which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States bear to the reserve funds held by it at the end of the taxable year upon all business transacted. Other foreign life insurance companies are not taxable under section 201 (b), but are taxable the same as other foreign corporations. See section 231.

Sec. 202. Gross income of life insurance companies.—(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, rents, and commissions. For inclusion in computation of tax of amounts specified in shareholder's commission 28.

(b) The term "reserve funds required by law" includes in the case of assessment insurance, surplus created by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the deposit of insurance held at the beginning and end of the taxable year.

Sec. 203. Net income of life insurance companies.—(a) In the case of a life insurance company the term "net income" means the gross income less—

(1) Tax-free interest.—The amount of interest received during the taxable year which under section 23 (b) (4) is excluded from gross income;

Art. 203 (a) (1)-1. Tax-free interest.—Interest which in the case of other taxpayers is excluded from gross income by section 22 (b) (4) but included in the gross income of a life insurance company by section 203 (a) is allowed as a deduction from gross income by section 203 (a) (1).

[Sec. 203. Net income of life insurance companies.]

(a) General rule.—In the case of a life insurance company the term "net income" means the gross income less—

(2) Reserve funds.—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate of 4 per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, to the amount of 3 per centum of the mean of the reserve fund required by law at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

Art. 203 (a) (2)-1. Reserve funds.—In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia, or by recognized tables of experience covering 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. If no general expenses are assigned to the reserve funds held at the beginning and end of the taxable year, the amount required by law is 33 1/3 per centum of the mean of such reserve funds held at the beginning and end of the taxable year.

[Sec. 203. Net income of life insurance companies.]

(a) General rule.—In the case of a life insurance company the term "net income" means the gross income less—

(4) Investment expenses.—Investment expenses during the taxable year in which any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

Art. 203 (a) (4)-1. Investment expenses.—The term "general expenses" as used in the Act means any expense incurred for the benefit of more than one department of the company rather than for the benefit of particular department thereof. Any assignment of such expenses to the investment department of the company for which a deduction is claimed under section 203 (a) (4) shall operate to subject the total investment expenses to the limitation provided in that section.

If no general expenses are assigned to or included in Investment expenses the deduction may consist of Investment expenses actually paid during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

Invested assets for the purpose of section 203 (a) (4) and this article are those which are owned and used, and to the extent used, for the purpose of producing the income Inferred in section 203 (a). The maximum allowance of one-fourth of 1 percent will not be granted unless it
is shown to the satisfaction of the Commissioner that such allowance is justified.

[Sec. 203. Net income of life insurance companies.]

(a) General rule.—In the case of a life insurance company the term "net income" means the gross income less—

(5) Taxes and expenses paid during the taxable year exclusive of 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 the property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder of a company upon his interest as shareholder, which are paid by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes;

Art. 203 (a) (5).—Taxes and expenses with respect to real estate.—The deduction allowed under section 203 (a) (5) includes taxes and expenses paid during the taxable year exclusively of 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 by the company without reimbursement from the shareholders. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. (See article 203 (a) (4).) As to real estate owned and occupied by the company see article 203 (b).—1.

[Sec. 203. Net income of life insurance companies.]

(a) General rule.—In the case of a life insurance company the term "net income" means the gross income less—

(5) Reasonable allowance, as provided in section 23 (1), for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence; and

Art. 203 (a) (6).—1. Depreciation.—The deduction allowed by section 203 (a) (6) for depreciation, as provided in article 203 (b), identified with that allowed other corporations by section 23 (1). The amount allowed by section 23 (1) 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 income specified in section 202 (a).

[Sec. 203. Net income of life insurance companies.]

(a) General rule.—In the case of a life insurance company the term "net income" means the gross income less—

(7) Interest.—All interest paid within the taxable year on its indebtedness, except on indebtedness incurred for the purpose of producing investment income or for the purpose of acquiring, constructing, or carrying on or maintaining property for the purpose of producing income, and all interest paid in lieu of the tax imposed by sections 13 and 14, shall be levied, collected, and paid for each taxable year upon the gross income of every life insurance company (other than a life or mutual insurance company) a tax of 15½ per centum of such interest.

Art. 203 (a) (7).—1. Interest.—The deduction allowed by section 203 (a) (7) for interest on indebtedness is the same as that allowed other corporations by section 23 (b) but this deduction includes interest on dividends held on deposit and surrendered during the taxable year. Reserve funds shall be credited with the excess of the dividends paid on such deposits, over the amount paid in by the policyholders of their policies. Reserve funds shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 203 (b) and 204 (b) (1) and 204 (b) (1) means only those companies subject to the tax imposed by section 204. The rate of the tax imposed by section 204 is 16½ per cent and the tax is imposed upon the special class net income as defined in section 203. The net income of insurance companies other than life or mutual is defined in section 204 and differs from the net income of other corporations. All provisions of the Act and of these regulations not inconsistent with the specific provisions of section 204 are applicable to the assessment and collection of the tax imposed by this section 204 (a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. Since section 204 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 203 will be for the taxable year ending December 31, 1939, and shall be on Form 1120. Insurance companies are entitled to the credits provided in section 26 (a) and (b).

Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 204 but are taxable as other foreign corporations. See section 231.

[Sec. 204. Insurance companies other than life or mutual.]

(b) Definition of income, etc.—In the case of an insurance company subject to the tax imposed by this section—

(1) Gross income.—"Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under section 23.

(2) Net income.—"Net Income" means the gross income as defined in paragraph (1) of this section less the deductions allowed by subsection (e) of this section; and

(3) Investment income.—"Investment income" means the gross income earned during the taxable year from interest, dividends, and rents, computed as follows:

To the extent, 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.
tual insurance companies (including inter-
insurers and reciprocal underwriters, but
not including mutual life or mutual marine
insurance companies) requiring their mem-
bers to make premium deposits to provide
for losses and expenses, the amount of pre-
miums received and returned to their policy-
ctors and the amount of premium deposits re-
tained for the payment of losses, expenses, and
returns.

Art. 207-1. Tax on mutual insurance
companies other than life.—All mutual
insurance companies other than life (in-
cluding foreign insurance companies car-
rying on an insurance business within the
United States) are subject to the tax im-
posed by section 207 and the rate of tax is 16½ percent. The tax is im-
pounded upon the special class net income
as defined in section 14. The net income of mutual insurance companies differs
from the net income of other corpora-
tions.

Foreign insurance companies not car-
rying on an insurance business within the
United States are not taxable under
section 207 but are taxable as other for-

Art. 207-3. Gross income of mutual in-
surance companies other than life.—The
gross income of mutual insurance com-
panies (other than life) consists of their
net receipt from the operation of the busi-
ness and of their income from all other
sources within the taxable year, ex-
cept as otherwise provided by the Act.
Gross income includes net premiums
(that is, gross premiums less returned
premises on policies cancelled or deduc-
tions on policies not taken), invest-
ment income, profits from the sale of
assets, and all gains, profits, and income
reported to the State insurance depart-
ment, except income specifically exempt
from tax. Premiums received by mutual
marine insurance companies which are
paid out for reinsurance should be elimi-
nated from gross income and the pay-
ments for reinsurance from disburse-
ments. Deposit premiums on perpetual
risks received and returned by mutual
fire insurance companies are treated in the same manner, as no re-
serve will be recognized covering liability
for such deposits. The earnings on such
deposits, including such portion, if any,
of the deposits as is not returned to the
policymakers upon cancellation of the
policies, must be included in the gross
income. A net decrease in reserve funds
required by law to be made within the taxable year must be included in the gross
income to the extent that such funds are
released to the general uses of the company and the extent provided in Supplement I
in the case of a foreign corporation engaged
carrying on an insurance business within
the United States or having an office or place of
business therein.

Art. 207-4. Required addition to re-
serve funds of mutual insurance com-
panies (other than life).—Mutual
insurance companies, other than life
insurance companies, may deduct from gross
income the net addition required by law
to be made within the taxable year to
reserve funds, including in the case of
assessment insurance companies the ac-
tual deposit of sums with State or Ter-
ritorial officers pursuant to law as addi-
tions to guarantee or reserve funds. Re-
serve funds “required by law” include not
only reserves required by express
statutory provisions but also reserves re-
quired by the rules and regulations of
State insurance departments when pro-
mulgated in the exercise of an appro-
priate power conferred by statute, but
do not include assets required to be held
for the ordinary running expenses of the
business, such as taxes, salaries, reins-
urance, and unpaid brokerage. Only
reserves commonly recognized as reserve
funds in insurance accounting are to be
taken into consideration in computing
the net addition to reserve funds re-
quired by law. In the case of a fire in-
surance company the only reserve fund
may include the “unearned premium”
fund. For a general defini-
tion of “reserve fund” see article 203
(a) (2)-1. Mutual hail and mutual cy-
clone insurance companies are entitled
deduct from gross income the net ad-
tion which they are required to make
to the “guarantee surplus” fund or simi-
lar fund. In the case of foreign ins-
urance companies the deductions provided
for by section 207 shall be allowed to the
extent provided in Supplement I in the
case of a foreign corporation engaged
carrying on an insurance business within
the United States or having an office or place of
business therein.

Art. 207-5. Special deductions allowed
mutual marine insurance companies.—
Mutual marine insurance companies should
include in gross income the gross
premiums collected on them by them
less amounts paid for reinsurance. They
may deduct from gross income amounts
paid to policyholders on account of pre-
miums previously paid by them, together
with the interest actually paid upon such
amounts between the date of ascer-

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gross income was derived, and a copy of the complete report should be furnished as soon as ready for filing. All provisions of the Act and these regulations not inconsistent with the specific provisions of section 202 are applicable to the collection of the tax imposed by section 207, and mutual insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

CHAPTER XXXV

Nonresident Aliens

Supplement H—Nonresident Alien Individuals

Sec. 211 Tax on nonresident alien individuals.—(a) No United States business or office. (1) General rule. All sources of income from the sources specified in subsection (a) (1), shall be taxable without regard to the provision of subsection (a) (1), except that the aggregate income from the sources specified in subsection (a) (1) shall be taxable only on income from sources within the United States. The phrase “engaged in personal service” in the meaning of this article, in the absence of exceptional circumstances.

(b) United States business or office. (1) A nonresident alien individual engaged in trade or business within the United States shall be taxable without regard to the provisions of subsection (a). As used in this section, section 129, section 154, 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 within the United States by a nonresident alien individual, foreign partnership, or foreign corporation, 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 at a total of ninety days during the taxable year and whose compensation is not paid or payable in the aggregate $5,000. Such phrase does not include the effecting of transactions in the United States for the account of others, or commodities through a resident broker, commission agent, or custodian.

(c) No United States business or office and gross income of more than $21,600. A nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein who has a gross income of any taxable year of more than $21,600 from the sources specified in subsection (a) (1), shall be taxable without regard to the provisions of subsection (a) (1), except that the aggregate gross income from the sources specified in subsection (a) (1) shall be taxable only on income from sources within the United States. The phrase “engaged in personal service” in the meaning of this article, in the absence of exceptional circumstances.

Ann. 211-3. Alien seamen, when to be regarded as residents.—In order to determine whether an alien seaman is a resident within the meaning of the income tax law, it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the flag of the United States and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel while carrying on foreign trade touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in article 211-4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1073 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. Residences, however, rebutting 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.

Ann. 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, thus acquired residence therein within the meaning of the Act. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overcome—

(1) In the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (a) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1073 or its equivalent, or (c) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) In other cases by (a) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien has filed Form 1073 or its equivalent, or (c) proof
of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

In any case in which an alien seeks to overcome the presumption of non-residency (c) or (2) by the internal-revenue officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits.

Art. 211-5. Loss of residence by alien.—An alien who has acquired residence in the United States retaining his status as a resident until he abandons the country or ceases to reside in 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 the taxable year in the United States.

Art. 211-6. Duty of employer to determine status of alien employee.—If wages are paid to aliens without withholding the tax, except as permitted in article 143-3, in the case of a resident of Canada or Mexico, the employer should be prepared to prove the status of the alien as provided in the foregoing articles. An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078, or an equivalent certificate of the alien establishing residence. An employer need not secure Form 1078 from the alien if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he had not at the time secured Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent evidence. The written statement of the alien employee may ordinarily be relied upon by the employer as proof that the alien is a resident of the United States.

Art. 211-7. Taxation of nonresident alien individuals.—For the purposes of this article and articles 212–1, 213–1, 214–1, and 217–2, nonresident alien individuals are divided into three classes: (1) nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in the taxable year not more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States; (2) nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year and deriving in the taxable year not more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States; and (3) nonresident alien individuals having an office or place of business in the United States or having an office or place of business therein.

(a) No United States business or office.—General rule.—A nonresident alien individual within class (1) referred to in the preceding paragraph is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 211 (a), the term "amount received" means "gross income" from sources within the United States, as defined in section 217-2, and all income so derived which is subject to the limitations prescribed by the provisions of section 119, minus any deductions properly allocable to such income.

(b) Aggregate more than $21,600.—A nonresident alien individual within class (2) referred to in the first paragraph of this article, is subject to the provisions of section 119, minus (1) the deductions properly allocable to such income; and (2) the so-called "charitable contributions" deduction provided in section 119 (c). Such nonresident alien is entitled to the credits against net income allowable to an individual by section 25, subject to the limitations provided in section 214. However, the tax thus computed under sections 11 and 12 shall in no such case be less than 10 percent of the gross amount of such fixed or determinable annual or periodical income from sources within the United States. Nonresident alien individual within class (3) is subject to the provisions of section 119 (c) or of this paragraph, but are (under the terms of the tax convention between the United States and Canada) subject to tax under the provisions of section 211 (a) and the special provisions of paragraph (c) of this article relating to such aliens.

(c) United States business or office.—A nonresident alien individual within class (3), referred to in the first paragraph of this article, is not taxable at the rate of 10 percent upon the items of gross income enumerated in section 211 (a). The net income from sources within the United States of such a nonresident alien individual (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 213) less the credits against net income allowable to an individual by section 25, is subject to the normal tax of 4 percent imposed by section 11 and the graduated surtax imposed by section 12 (b).

As used in sections 211, 119, 143, 144, and 231, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year but does not include the performance of personal services for a nonresident alien individual, for partnership, or for a corporation not engaged in trade or business within the United States by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year, and whose compensation for such services does not exceed in the aggregate $3,000. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian. (See also article 212-1.)
Whether a nonresident alien has an "office or place of business" within the United States depends on the facts in a particular case. The term "office or place of business," however, implies a place for the regular transaction of business and does not include a place where casual or incidental transactions might be, or are, effected.

Neither the beneficiary nor the grantor of a trust, whether revocable or irrevocable, is deemed to be engaged in trade or business in the United States or to have an office or place of business therein, merely because the trustee is engaged in trade or business in the United States or has an office or place of business therein.

Sec. 211. 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 ships, whether or not documented under the laws of a foreign country which require an equivalent exemption to citizens of the United States is not taxable in the United States unless the income is generated in the United States and shall not be included in gross income and shall be exempt from taxation under this title.

Art. 212-1. Gross income of nonresident individuals.—In general, in the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 119. (See articles 119-1 to 119-14.) The items of gross income from sources without the United States and therefore not taxable to nonresident aliens are described in section 119(c). As to who are nonresident alien individuals see articles 211-2 to 211-6.

Income received by a resident alien from sources without the United States is taxable although such person may become a nonresident by alienation of his or its receipt and prior to the close of the taxable year. Conversely, income received by a nonresident alien from sources within the United States is not taxable though such person may become a resident alien subsequent to its receipt and prior to the close of the taxable year.

(a) No United States business or office.—The gross income of a nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year, whether such alien comes within article 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 of stocks, securities or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(b) United States business or office.—The gross income of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States, or had an office or place of business therein is not limited to the items of gross income specified in section 211(a), but includes any item of gross income which is treated as income from sources within the United States, except those items which are excluded from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See sections 212(b), 213, 116, 119, and 212(b).)

In general, any nonresident alien individual who performs personal services within the United States is considered as being engaged in trade or business within the United States and therefore his net income from sources within the United States, including his compensation, is subject to the normal tax of 4 percent and the surtax. However, the place of business within United States business or office 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 $2,000. 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 118(b).

The effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian does not bring a nonresident alien individual within the class of nonresident alien individuals engaged in trade or business within the United States, but if a nonresident alien individual by reason of rendering personal services in the United States, or for other reasons, is classed as a nonresident alien individual engaged in trade or business within the United States or having an office or place of business therein, he is taxable upon all income from sources within the United States, including profits derived from the effecting of such transactions. Such a nonresident alien individual is required to include in gross income profits from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein.

Art. 212-2. Exclusion of earnings of foreign ships from gross income.—So much of the income from sources within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States, or had an office or place of business therein as consists of earnings derived from the operation of a ship or ships under foreign flag is deemed exempt from taxation by the Federal Government under the Constitution, except as provided by section 119, and such profits derived from the effecting of transactions in the United States of ships, whether or not documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States, are exempt from taxation by the United States and to corporations organized in the United States, shall not be included in the gross income of foreign individuals engaged in trade or business in the United States as consists of earnings derived from the operation of a ship or ships under foreign flag. Such profits are also exempt from taxation on the United States by the foreign government under the Constitution.

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, or to the vocational rehabilitation fund. (See sections 22 to 23(e), and 23(e)(2).)

(b) Losses.—(1) The deduction, for losses not connected with income from sources within the United States, of the losses incurred in transactions entered into for profit, allowed by section 23(e)(2) shall be allowed whether or not connected with income from sources within the United States, but only if the profit, if such transaction had resulted in a profit, would be taxable under this title.

(2) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 23(e)(3), shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States.

(c) Charitable, etc., contributions.—The so-called "charitable contribution" deduction allowed by section 23(e)(6) shall be allowed whether or not connected with income from sources within the United States, or to community chest, funds, or foundations organized in the United States, or to the vocational rehabilitation fund.

Art. 213-1. Deductions allowed nonresident alien individuals.—(a) No United States business or office.—(1) General rule.—In general, a nonresident alien individual not engaged in trade or
business within the United States and not having an office or place of business therein at any time during the taxable year is not allowed any allowance for deductions and credits allowed to him in this title, by filing a claim for refund or cause to be filled 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) of article 221-2, 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 sources within the United States, as, for example, from wages, salaries, dividends from stocks or bonds held directly by him, or from securities held for him by a custodian resident in the United States, so that his total gross fixed or determinable annual or periodical income from United States sources is in excess of $21,600 and a return of income is not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the fixed or determinable annual or periodical income from all sources within the United States, concerning which he has information without allowance for deductions and credits, and will assess the tax and collect it from one or more of the sources of income within the United States. Such nonresident alien may make a full and accurate return on Form 1040 NR—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
FEDERAL REGISTER, Saturday, February 11, 1939

and pay the tax, see paragraph (b) of article 217-2, which is hereby made equally applicable in the case of a nonresident alien individual coming within the provisions of this paragraph.

(b) United States business or office—Unless a nonresident who at any time within the taxable year was engaged in trade or business within the United States or had an office or place of business therein shall file, or cause to be filed, with the collector, a true and accurate return of his total income (not the net income) from sources within the United States, so that his total income calls for the assessment of a surtax, the return shall be filed on the basis of the calendar year or 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 the calendar year, then on or before the fifteenth day of June.

(b) Exemption from responsibility—Subject to such limitations, exceptions and under such regulations as may be prescribed by the Commissioner, with the approval of the nonresident alien individuals subject to the tax imposed by section 211 (a) may be exempted from the requirement of filing returns of such tax.

Art. 217-1. Time and place for filing returns of nonresident alien individuals.—The return in the case of a nonresident alien individual must be made on or before the 15th day of the sixth month following the close of the fiscal year or on or before the 15th day of June, if on the basis of the calendar year. The return must be filed with the collector of internal revenue for the district in which the nonresident alien individual has his principal place of business in the United States, or if he has no principal place of business in the United States, then with the collector of internal revenue at Baltimore, Md. For failure to make and file return within the time prescribed see section 291. For cases in which no return is required see paragraph (a) of article 217-2.

Art. 217-2. Return of income.—(a) No United States business or office

(1) General rules.—If the tax liability of a nonresident alien individual, not engaged in business or business within the United States and not having any office or place of business therein at any time during the taxable year, is fully satisfied at the source a return of income is not required. 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, shall be subject to section 211 and shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. (See article 143-4.)

(b) Aggregate more than $21,600.—A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States and not having an office or place of business therein at any time during the taxable year deriving in such year more than $21,600 gross amount of fixed or determinable annual or periodical income from sources within the United States. 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 broker, commission merchant, or custodian, or profits derived from the sale of the United States of personal property or real property located therein. As to the duty of the representative or agent of such an individual to file a return and pay the tax, see paragraph (b) of this article, which is hereby made equally applicable in the case of a nonresident alien coming within the provisions of this paragraph.

(b) United States business or office.—If a nonresident alien individual at any time within the taxable year is engaged in trade or business within the United States or has an office or place of business therein he shall make or have made a full and accurate return on Form 1040 NR-a of all his fixed or determinable annual or periodical income 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, 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, so that his total income calls for the assessment of a surtax, the return shall be filed on the basis of the calendar year or on or before the 15th day of the sixth month following the close of the fiscal year.

The responsible representative or agent within the United States of a nonresident alien individual who at any time during the taxable year was engaged in trade or business within the United States or had an office or place of business therein at any time during the taxable year, or a member of a partnership, or a corporation which is treated as income 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, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. (See article 143-4.)

Art. 218-1. Date on which tax shall be paid by nonresident alien individual.—In the case of a nonresident alien individual the tax is to be paid or before the 15th day of June following the close of the calendar year. The return is the basis of the tax, 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 section 281-4.

Art. 219. Partnerships.—For the purpose of this title, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged and as having an office or place of business within the United States if the partnership of which he is a member has such an office or place of business.
ject to the provisions of section 211 (a) or 211 (c), as the case may be, depending on whether in the taxable year he is engaged in a nonresident foreign corporation gross income or periodical income from sources within the United States of more than $24,000, if he is not otherwise engaged in trade or business within the United States and has no office or place of business therein. A nonresident foreign corporation shall be defined and described in section 119 (a), (2). The term "partnership" includes any association, whether in the case of a nonresident alien individual. (See article 211-7.)

**CHAPTER XXVII**

**Foreign Corporations**

**Supplement I—Foreign Corporations**

Sec. 231. Tax on foreign corporations.—(a) Nonresident corporations.—There shall be levied, collected, and paid for each taxable year the tax imposed by sections 13 and 14, upon the amount received by every foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, and 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. For the purposes of section 231 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Act as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the definition of fixed or determinable annual or periodical income see article 143-2. The items of fixed or determinable annual or periodical income from sources within the United States received by a corporation organized under the laws of France, which are exempt from Federal income tax under the provisions of the convention and protocol between the United States and France signed April 27, 1932, and effective January 1, 1938, are described in article 145-2.

The fixed or determinable annual or periodical income from sources within the United States, including royalties, but excluding dividends, of a nonresident foreign corporation is taxable at the rate of 15 percent upon the amount received by such corporation from sources within the United States taxable at the rate of 10 percent, except that in the case of a nonresident foreign corporation organized under the laws of a contiguous country, such rate of 10 percent shall be reduced to not less than 5 percent as may be provided by treaty with such country.

(b) Resident corporations.—A resident foreign corporation engaged in trade or business within the United States or having an office or place of business therein shall be taxable as provided in section 14 (e) (1).

(c) Gross income.—In the case of a foreign corporation gross income includes only the gross income from sources within the United States.

(d) Ships under foreign flag.—The income of a foreign corporation, which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States, shall not be included in gross income and shall be exempt from taxation under this title.

Art. 231-1. Taxation of foreign corporations.—For the purposes of this article and articles 231-2, 232-1, 232-2, 233-1, 233-2, and 233-3, the foreign corporations are divided into two classes: (a) foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein at any time within the taxable year, referred to in the regulations as resident foreign corporations (see section 901-9); and (b) foreign corporations which at any time within the taxable year are engaged in trade or business within the United States or have an office or place of business therein, referred to in the regulations as resident foreign corporations (see section 901-8).

(a) Nonresident foreign corporations.—A nonresident foreign corporation is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 231 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Act as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the definition of fixed or determinable annual or periodical income see article 143-2. The items of fixed or determinable annual or periodical income from sources within the United States received by a corporation organized under the laws of France, which are exempt from Federal income tax under the provisions of the convention and protocol between the United States and France signed April 27, 1932, and effective January 1, 1938, are described in article 145-2.

The fixed or determinable annual or periodical income from sources within the United States, including royalties, but excluding dividends, of a nonresident foreign corporation is taxable at the rate of 15 percent upon the amount received by such corporation from sources within the United States taxable at the rate of 10 percent, except that in the case of a nonresident foreign corporation organized under the laws of a contiguous country, such rate of 10 percent shall be reduced to not less than 5 percent as may be provided by treaty with such country.

(b) Resident corporations.—A resident foreign corporation is taxable only on the items of fixed or determinable annual or periodical 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.

Art. 231-2. Gross income of foreign corporations.—In the case of a foreign corporation, including a life insurance company not carrying on an insurance business within the United States and holding no reserve funds upon business transacted within the United States (see section 201 (b) (3)), an insurance company other than life or mutual not carrying on an insurance business within the United States (see section 204 (a) (3)) and a mutual insurance company other than life not carrying on an insurance business within the United States (see section 207 (a)), the term "gross income" means gross income from sources within the United States as determined and described in section 119. (See articles 119-1 to 119-14.) The items of gross income from sources without the United States and therefore not taxable to foreign corporations are described in section 119 (c). As to the definition of a foreign corporation see section 901 (a) (2) and (5). As to foreign life insurance companies, see article 201 (b) -2. As to foreign corporations formed or availed of to avoid the tax, see to personal holding companies organized under the laws of foreign countries, see article 406-1. As to foreign personal holding companies, see Chapter XXXIV.

(a) Nonresident foreign corporations.—A nonresident foreign corporation is taxable under section 231 (a) only on the items of fixed or determinable annual or periodical 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 of a foreign corporation not carrying on an insurance business within the United States of a resident foreign corporation is taxable only on the items of fixed or determinable annual or periodical 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.
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 excused from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See sections 22 (b), 119, and 231 (d).)

A resident foreign corporation is allowed deductions for 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 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 is determined as provided in section 119. As to foreign life insurance companies, see article 201 (b)–2.

As to foreign corporations formed or availed of to avoid surtax, see article 102-4. As to personal holding companies organized under the laws of foreign countries, see article 406-1. As to foreign personal holding companies, see Chapter XXXIV.

Sect. 233. Allowances of deductions and credits.—A foreign corporation shall receive the same deductions and credits as are allowed to it in this title only by filing or causing to be filed with the collector a true and accurate return of the income received from all sources in the United States, in the manner prescribed in this title; that is, therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

A resident foreign corporation may exclude from gross income under section 231 (d) so much of its income from sources within the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of a foreign country, to the same extent as provided in article 212-2 with respect to nonresident alien individuals.

A nonresident foreign corporation is not required to include in its 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.

Sect. 234. Credits against tax.—Foreign corporations are allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 29 (a) and (b). Inasmuch as a nonresident foreign corporation is taxable under section 231 (a) only upon fixed or periodical income upon which the tax was not fully satisfied at the source, foreign corporations treated as income 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.

A foreign corporation which 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.

A nonresident foreign corporation not having any office or place of business in the United States the total amount of tax imposed by this title shall be
paid, in lieu of the time prescribed in section 56, on the 15th day following the close of the calendar year, or if the return should be made on the basis of a fiscal year, on the 15th 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.

Arr. 236-1. Dates on which tax shall be paid by foreign corporations.—(a) Nonresident foreign corporations.—In the case of a nonresident foreign corporation the total amount of tax imposed by section 231 (a) shall be paid on the 15th day of June following the close of the calendar year, or if the return should be made on the basis of a fiscal year, then on the 15th day of the sixth month following the close of the fiscal year.

As to payment of the tax in installments, see article 56-1.

The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel who are 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 business within a possession of the United States, although such citizen was actively engaged in the management of such corporation, does not represent income derived from the active conduct of a trade or business within the possession of the United States, either on the taxpayer's own account or as an employee or agent of another.

A citizen of the United States who on account of the nature and amount of his income cannot meet the 80 percent and the 50 percent requirements of the statute, but who receives earned income from sources within a possession of the United States is not deprived of the benefits of the provisions of section 116 (a), provided he is away from the United States or having an office or place of business therein. 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).

For a determination of the income from sources within the United States, see section 119. A citizen entitled to the benefits of section 251 is required to file with his individual return Form 1040 or 1040 A, the schedule on Form 1040 B. If a citizen entitled to the benefits of section 251 has no income from sources within the United States, he is not required to file a return or the schedule on Form 1040 B.

Example: On July 1, 1938, A, who is a citizen of the United States, went to Puerto Rico and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1938 of some Puerto Rican real estate not connected with his trade or business. In the first six months of 1938 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1938. Inasmuch as for the applicable part (July 1, 1938, to December 31, 1938) of the 3-year period immediately preceding the close of the taxable year (the calendar year), 80 percent of A's gross income ($20,000, or 80 percent of $40,000) was derived from sources within a possession of the United States, and

or corporations within the United States, whether derived from sources within or without the United States.

(c) Tax in case of corporations.—A domestic or a domestic corporation (computed without the benefit of this section) for the three-year 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 domestic corporations deriving income from sources within a possession of the United States shall be paid on the 15th 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 15th day of the third month following the close of the fiscal year. As to payment of the tax in installments, see article 56-1.

Sec. 237. Foreign insurance companies.—For special provisions relating to foreign insurance companies, see Supplement C.

Sec. 238. Affiliation.—A corporation shall not be deemed to be affiliated with any other corporation within the meaning of section 141.

CHAPTER XXVIII
Income From Sources Within Possessions of United States

Supplement J—Possessions of the United States

Sec. 261. Income from sources within possessions of the United States.—(a) General rule.—In the case of citizens of the United States, domestic corporations, and foreign corporations as the following conditions, gross income means only gross income from sources within the United States:

(1) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of 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.

(2) If, in the case of such corporation, 50 percent 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.

(3) If, in the case of such citizen, 50 percent 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), the term "amounts received in United States" shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) Tax in case of corporations.—A domestic or a domestic corporation (computed without the benefit of this section) for the three-year 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 domestic corporations deriving income from sources within a possession of the United States shall be paid on the 15th 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 15th day of the third month following the close of the fiscal year.

(d) Definition.—As used in this section the term "possessions of the United States" does not include the Virgin Islands of the United States.

(1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed to them in the United States; in the manner prescribed in this section; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

(b) Credits against tax.—Persons entitled to the benefit of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States.

(1) A corporation entitled to the benefit of this section shall not be allowed the credit for income so derived from sources outside the United States.

(c) Allocations and credits.—Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States and domestic corporations deriving income from sources within a possession of the United States 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 domestic corporations deriving income from sources within a possession of the United States and domestic corporations deriving income from sources within a possession of the United States shall be paid on the 15th 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 15th day of the third month following the close of the fiscal year.

As to payment of the tax in installments, see article 56-1.

Sec. 251. Income from sources within possessions of the United States.—(a) General rule.—In the case of citizens of the United States, domestic corporations, and foreign corporations as the following conditions, gross income means only gross income from sources within the United States: 

(1) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of 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.

(2) If, in the case of such corporation, 50 percent 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.

(3) If, in the case of such citizen, 50 percent 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), the term "amounts received in United States" shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) Tax in case of corporations.—A domestic or a domestic corporation (computed without the benefit of this section) for the three-year 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 domestic corporations deriving income from sources within a possession of the United States shall be paid on the 15th 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 15th day of the third month following the close of the fiscal year.

As to payment of the tax in installments, see article 56-1.

Sec. 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, if the following conditions, gross income means only gross income from sources within the United States:

(1) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for the 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 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.

Inasmuch as for the applicable part (July 1, 1938, to December 31, 1938) of the 3-year period immediately preceding the close of the taxable year (the calendar year) 80 percent of A's gross income ($20,000, or 80 percent of $40,000) was derived from sources within a possession of the United States.
United States and as 50 percent or more of his gross income ($20,000, or 50 percent of $40,000) for such part of the 3-year period was derived from the active conduct of a trade or business within a possession of the United States, he is required to report in gross income, in his return for 1938 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

**ART. 251-2. Income received within the United States.**—Notwithstanding the provisions of section 251 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned thereto. For instance, if in the example given in article 251-1, the taxpayer during the latter part of 1938 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the Puerto Rican real estate, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 251 with respect to other items of gross income excluded by that section.

**ART. 251-3. Tax in case of corporations.**—A domestic corporation entitled to the benefits of section 251 is taxable at the rate of 161/2 percent as provided in sections 251 (c) and 14 (d) and is not subject to the tax imposed by section 13.

**ART. 251-4. Definition.**—The term “United States” as used herein includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia. The term “possessions of the United States,” as used in sections 251 and 252 and article 253-1, this article, and article 252-1, includes Puerto Rico, the Philippine Islands, the Panama Canal Zone, Guam, American Samoa, Wake, Palmyra, and the Midway Islands; it does not include the Virgin Islands. The Philippine Islands come within the classification of “possessions of the United States” for Federal income tax purposes, notwithstanding the establishment of the Commonwealth of the Philippines under the Act of March 31, 1948 (54 Stat., 209).

**ART. 251-5. Deductions allowed citizens and domestic corporations entitled to the benefits of section 251.**—In the case of a citizen entitled to the benefits of section 251, the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if to the extent commensurate with income from sources within the United States. The provisions of article 213-1 relating to the allowance to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States or an office or place of business therein, of the deductions provided in paragraphs (2) and (3) of section 23 (e) for losses not connected with the trade or business are applicable in the case of citizens entitled to the benefits of section 251. The provisions of this article pertaining to such nonresident alien individuals for contributions provided in section 23 (e) are also applicable in the case of such citizens.

**ART. 251-6. Allocations 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 gross income (not the net income) derived from such 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 159.

**ART. 252. Status of citizens of United States possession.**—A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. (See sections 211-219.) For Federal income tax purposes a citizen of a possession of the United States who is not otherwise a citizen of the United States, is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization. The fixed or determinable annual or periodical income from sources within the United States of a citizen or possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. (See article 143.)

For the purpose of this article citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (1) citizens of possessions of the United States who are citizens entitled to the benefits of section 251 as 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 contributions provided in section 23 (e) are 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 contributions provided in section 23 (e) are applicable in the case of such corporations. The Act referred to in section 252 (d) provides that income taxes then or thereafter in force in the United States shall apply to the Virgin Islands, but the taxes shall be paid into the treasury of the Virgin Islands. Accordingly, persons are taxed there under the provisions of the Revenue Act of 1933.  

**Chapter XXXII**  

**China Trade Act Corporations**  

**Supplement E—China Trade Act Corporations**

**Sec. 291. Taxation in general.**—A corporation organized under the China Trade Act, 1932, shall be taxable as provided in section 14 (d). For inclusion in computation of tax of any income so qualified in shareholder’s consent, see section 23.
Art. 262. Credits against net income.—(a) Allowance of credit.—For the purpose only of the taxes imposed by sections 14 and 262 of this Act the credits allowable are the same as in the case of other domestic corporations.

Art. 262-2. Credits allowed China Trade Act corporations.—In addition to the credits allowed under section 26 (a) and (b), a China Trade Act corporation has a net income from sources within China (determined in a similar manner as provided in section 119) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date. Provided, That in no case shall the diminution, by reason of such credit, of the tax imposed by such section 14 (computed without regard to this section) exceed the amount of the special dividend referred to in section 14 (b) of this Act and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce. The decrease in the tax imposed by section 602 of the Revenue Act of 1938 or section 106 of the Revenue Act of 1935 by reason of such credit must not, however, exceed the amount of the special dividend referred to in section 262 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce. The decrease in the tax imposed by section 602 of the Revenue Act of 1938 or section 106 of the Revenue Act of 1935 by reason of such credit must not exceed the amount 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.

(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 the last day of the taxable year, has been paid in cash dividends by the corporation, the income from which is included in the return of a corporation organized under the China Trade Act of 1922, is not taxable under section 14 (d) by reason of such credit, of the tax imposed by such section 14.

(2) The amount which such special dividend in addition to all other amounts, payable or to be payable 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 section 168 or 602 (computed without regard to this section) of the Revenue Act of 1938 or the Revenue Act of 1935 exceed the amount by which such special dividend exceeds the decrease permitted by section 262 in the tax imposed by section 14 (d) by reason of such credit must not exceed the amount of the special dividend referred to in section 262 (b) and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce. The decrease in the tax imposed by section 602 of the Revenue Act of 1938 or section 106 of the Revenue Act of 1935 by reason of such credit must not exceed the amount 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.

(c) Ownership of stock.—For the purposes of this section the term "China" shall have the same meaning as when used in the China Trade Act, 1922.

Art. 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 states or for taxes of the China Trade Act corporation on account of the allowance of special dividends, except that the credits allowed by the Secretary of Commerce as provided in section 262 (b) for the purpose of the tax imposed by section 14 (d) is 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 $300,000

Tax as 16% percent 48,000

Total net tax 48,000

Second Computation

Allowing Special Credit Against Net Income

Net Income $200,000

Amount of income subject to tax under section 14 (d) None

Since the special dividend ($35,000) exceeds the diminution of the tax ($33,000) on account of the allowance of the special credit against net income, the entire amount of the special credit is allowable and the corporation has no income tax liability for 1938.

For the purpose of the excess-profits tax it is necessary to make two computations, first, without allowing the special credit against net income, and, second, allowing such credit. The computations are as follows:

First Computation

Without allowing the special credit against net income

Net Income $200,000

Less: 10 percent of the value declared in the capital stock tax return for the capital stock tax year ended June 30, 1938 (10 percent of $1,000,000) 150,000

Net Income subject to excess-profits tax 50,000

Less: Amount taxable at 6 percent, portion of net income in excess of 10 percent and not in excess of 16 percent of the adjusted declared value of the capital stock ($500,000 minus $100,000) 50,000

Amount taxable at 12 percent None

Excess-profits tax at 6 percent ($500,000) 0,000

The computations are as follows:
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) individuals citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible from net income. 200,000

Amount of income subject to excess-profits tax: None

Since the diminution of the excess-profits tax ($5,000) on account of the special credit against net income does not exceed the amount by which the special dividend ($36,000) exceeds the diminution of the income tax ($33,000) on account of such credit, the entire amount of the special credit ($200,000) is allowable and the corporation has no excess-profits tax liability for 1928.

Ann. 290-3. Meaning of terms used in connection with China Trade Act corporations.—A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922.

The term “China” means (1) China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, (2) the Crown Colony of Hongkong, and (3) the Province of Macao.

The term “special dividend” means the amount which during the year ending on March 15 succeeding the close of the corporation’s taxable year is distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or 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 282 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.

Ann. 290-4. Withholding by a China Trade Act corporation.—Dividends distributed by a corporation organized under the China Trade Act, 1922, which are treated as income from sources within the United States under the provisions of section 119 of the Act are subject to withholding at the rate of 10 percent when paid to persons (other than residents of China) who are (a) nonresident aliens, (b) nonresident partnerships, or (c) nonresident foreign corporations. The 10 percent rate of withholding specified in this article with respect to dividends shall be reduced in the case of shareholders who are (a) nonresident aliens residents of a contiguous country or (b) nonresident foreign corporations organized under the laws of a contiguous country, to such rate (not less than 5 percent), as may be provided by treaty with such country. As to reduction in rate of withholding (a) in the case of nonresident alien individuals, residents of Canada, see article 144-4; (b) in the case of nonresident foreign corporations organized under the laws of Canada, see article 144-1.

CHAPTER XXX

Assessment and Collection of Deficiencies

Supplement I—Assessment and Collection of Deficiencies

Sec. 271. Definition of deficiency.—As used in this title in respect of a tax imposed by this title “deficiency” means—

(a) The amount by which the tax imposed by this title exceeds the amount shown as the tax by the taxpayer upon his return; but the amount so shown on the return shall be increased by the amount previously assessed (or collected without assessment) as a deficiency, and decreased by the amount of credit, refund, or otherwise repaid in respect of such tax; or

(b) If no amount so shown as the tax by the taxpayer upon his return, or if no return is made by the taxpayer, then the amount determined to be the correct amount of tax imposed by this title shall be increased by the amount previously assessed (or collected without assessment) as a deficiency; but such amounts previously assessed, or collected without assessment, shall first be decreased by the amount previously credited, refunded, or otherwise repaid in respect of such tax.

Sec. 271-1. Deficiency defined.—Section 271 by its definition of the word “deficiency” provides a term which will apply to any amount of tax determined to be due in respect of any taxable year beginning after December 31, 1926, in excess of the amount of tax reported by the taxpayer for such year; or in excess of the amount of tax 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” is called a deficiency within the meaning of the Act.

When a case is considered for the first time, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount shown by the taxpayer upon 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 reported by the taxpayer decreased by the amount of the credit or refund.

Sec. 272. Procedure in general.—(a) Petition to Board of Tax Appeals.—If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to such taxpayer and his estate. Within ninety days after such notice is mailed (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the amount of a deficiency in respect of the tax imposed by this title. The amount of a deficiency in respect of the tax imposed by this title shall be redetermined in court for its collection or refund, or both, as determined by the Board of Tax Appeals, and if the Board shall determine that the deficiency should not be redetermined, or if the Board shall determine that the deficiency is not existent, the deficiency shall be considered as finally determined and the Board shall so advise the taxpayer, and the taxpayer shall then have the right to appeal from such determination to the Circuit Court of Appeals for the district, circuit or division in which the taxpayer resides.
Section 273, relating to jeopardy assessments;
Section 274, relating to bankruptcy proceedings; and
Section 272 of the Revenue Act of 1926, as amended, relating to assessment or collection of the amount of the deficiency determined by the Board pending court review.

(b) Collection of deficiency found by Board.—If the taxpayer files a petition with the Board, the amount of the deficiency determined as the deficiency by the opinion of the Board which has become final shall be assessed and paid upon demand from the collector. No part of the amount determined as a deficiency by the Commissioner, by the decision of the Board which has become final shall be assessed or 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, which has been mailed to the taxpayer, shall be assessed, and shall be paid upon demand from the collector.

(d) Waiver of restriction.—The Board shall at any time have the right, by a signed notice in writing filed with the Commissioner, to waive provisions of 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 amount of a deficiency even if the amount so redetermined is greater than the amount of the deficiency determined by the taxpayer, and to determine whether any penalty, additional amount or addition to the tax determined by the Board has been or will be made on the basis of what would have been the correct amount of tax but for the mathematical error appearing upon the face of the return, an amount of tax in excess of which 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) as a notice of deficiency until notice of such deficiency has been mailed, as provided in subsection (a) of this section, relating to assessment and collection of the whole or any part of the deficiency.

(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 taxable year, except in such case of fraud, and except as provided in subsection (e) of this section, relating to assessment and collection of the whole or any part of the deficiency.

(g) Address for notice of deficiency.—In the absence of notice by the Commissioner under section 272 (c) of the existence of a deficiency in respect of any tax imposed by Title I (see sections 57 and 271), the Commissioner is authorized to notify the taxpayer of the deficiency by registered mail. If a married taxpayer, his husband and wife shall have notified the Board that a separate return of the husband and wife is being made, the Commissioner may, unless he has been notified by either spouse that a separate return has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified a separate notice of deficiency, that is a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in the first paragraph of section 272 (a), relating to separate returns, should be made to the Board of Internal Revenue, Washington, D. C., for the attention of the Income Tax Unit, Records Division. Within 90 days after notice of the deficiency is mailed, as provided in section 272 (a), relating to separate returns, the Board of Board of Tax Appeals for a redetermination of the deficiency. In determining such 90-day period, Sunday or a legal holiday in the District of Columbia is not to be counted as the ninetieth day.

(h) Final decision of Board.—For the purposes of this title on the date on which a decision of the Board becomes final shall be determined according to the provisions of section 272 (c) of 1926.

(i) Prorating of deficiency to installments.—If the taxpayer has elected to pay the tax imposed by Title I by installments, and after notice of such deficiency has been mailed, the deficiency shall be prorated to the four installments. Except as provided in jeopardy assessments, that part of the deficiency so prorated to any installment the date for payment of which has 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 Board.

(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 in such subsection, the deficiency, payment of such deficiency for a period not exceeding double the amount of the deficiency, or an extension for the purpose of the extension.

(k) Address for notice of deficiency.—In the absence of notice by the Commissioner under section 272 (c) of the existence of a deficiency in respect of any tax imposed by Title I (see sections 57 and 271), the Commissioner is authorized to notify the taxpayer of the deficiency by registered mail. If a married taxpayer, his husband and wife shall have notified the Board that a separate return of the husband and wife is being made, the Commissioner may, unless he has been notified by either spouse that a separate return has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified a separate notice of deficiency, that is a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in the first paragraph of section 272 (a), relating to separate returns, should be made to the Board of Internal Revenue, Washington, D. C., for the attention of the Income Tax Unit, Records Division. Within 90 days after notice of the deficiency is mailed, as provided in section 272 (a), relating to separate returns, the Board of Board of Tax Appeals for a redetermination of the deficiency. In determining such 90-day period, Sunday or a legal holiday in the District of Columbia is not to be counted as the ninetieth day.

Except as stated in paragraphs (1), (2), (3), (4), and (5) of this article, no assessment of a deficiency in respect of a tax imposed by Title I shall be deemed to have been made until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day period, nor, if a petition has been filed with the Board, until the decision of the Board has become final, as to the date on which a decision of the Board becomes final, see section 1005 of the Revenue Act of 1926 (paragraph 16 of the Appendix to these regulations).

(1) If a taxpayer is notified of an additional amount of tax due on account of a mathematical error appearing upon the face of the return, such notice is not to be considered as a notice of a deficiency, and the taxpayer has no right to file a petition with the Board upon the basis of such notice, nor is the assessment of such additional tax prohibited by the provisions of section 272 (a).

(2) If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, such deficiency shall be assessed immediately, notwithstanding subsection (a) of this section.

(3) Upon the adjudication of bankruptcy of any taxpayer or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency determined by the Commissioner in respect of the tax shall be assessed immediately, irrespective of the provisions of section 272 (a), if such deficiency has not been assessed in accordance with law prior to the adjudication of bankruptcy or the appointment of a receiver. (See sections 274 and 298 and articles 274–1 and 274–2.)

(4) (a) If the Board renders a decision and determines that there is a deficiency in respect of the income tax imposed by Title I (see sections 57 and 271), the Commissioner is authorized to notify the taxpayer of the deficiency by registered mail. If a married taxpayer, his husband and wife may, unless he has been notified by either spouse that a separate return has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified a separate notice of deficiency, that is a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in the first paragraph of section 272 (a), relating to separate returns, should be made to the Commissioner in the District of Columbia. The Board may, unless he has been notified by either spouse that a separate return has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified a separate notice of deficiency, that is a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in the first paragraph of section 272 (a), relating to separate returns, should be made to the Commissioner in the District of Columbia.

(b) If the Commissioner files a petition for review and (1) if the taxpayer has not filed a petition for review within three months after the decision of the Board is rendered, any petition which has been filed by the taxpayer, but the necessary bond referred to in section 1001 (c) of the Revenue Act of 1926, as amended, has not been filed with the
the Board on or before the time his petition for review is filed, the amount determined as a deficiency shall be assessed 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 with the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States as provided in section 1126 of the Revenue Act of 1926, as amended by the Act entitled "An Act to amend the second Liberty Bond Act, as amended, and for other purposes," approved February 4, 1933 (49 Stat. 20).

The amount of the deficiency and additions thereto shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand from the collector. Payment of the deficiency and additions thereto before the expiration of the extension will not relieve the taxpayer from paying the entire amount of interest provided for in the extension. (See section 226.)

Sec. 272. Jeopardy assessments.—(a) Authority for making.—If the Commissioner believes that the assessment or collection of a deficiency will be in jeopardy, he shall immediately assess such deficiency (together with all interest, additional amounts, and, if his determination is made 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 immediately, and 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 thereof 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 Collector 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 a deficiency 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 under the Act, and all interest, additions, and demand from the collector, or after the taxpayer has filed a petition for review of the decision of the Board.

(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 30 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 of which notice has been mailed to the taxpayer in accordance with the provisions of section 272 (a) prohibiting the determination of additional deficiencies, and whether or not the taxpayer has filed a petition with the Board of Tax Appeals. The Commissioner may, at any time before the decision of the Board is rendered, abate such assessment, or any unpaid part 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 reevaluate the entire amount of the deficiency assessed and 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) Expulsion of right to assess.—A jeopardy assessment may not be made after the decision of the Board if the petition for review of the decision of the Board has been filed by the taxpayer.
of collection of the whole or any part of the amount of the assessment by filing with the collector a bond, amount, not exceeding double the amount as to which the stay is desired, and with such sureties, as the collector determines, the payment of so much of the amount, the collection of which is proscribed by the bond, as is not abated by a decision of the Board, which has become final, together with interest thereon at the rate of six percent per annum from the date of jeopardy notice and demand, to the date of the notice and demand made after the expiration of the 90-day period. If a petition is not filed with the Board within the 90-day period, the collector will be so advised, and, if collection of the deficiency has been stayed by the filing of a bond, within 10 days after the date of jeopardy notice and demand, he shall 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 jeopardy notice and demand, the amount of the amount assessed, the collection of so much thereof as is covered by the bond will be stayed. The taxpayer may at any time waive the stay of collection of the whole or any part of the amount covered by the bond. If, as a result of such waiver any part of the amount covered by the bond is paid, or if any portion of the jeopardy assessment is abated by the Commissioner before the decision of the Board is rendered, then the bond shall be proportionately reduced. If the Board determines that the amount assessed is greater than the correct amount of the tax, the bond will also be proportionately reduced. If the Board determines that the amount assessed is less than the amount determined as the amount which should have been assessed, the excess shall be credited to the taxpayer for the amount of the jeopardy assessment. Regardless of whether the taxpayer has filed a petition with the Board, he is required to notify the Board of such assessment or abatement, and the Board has jurisdiction to determine the amount of the deficiency together with all other amounts assessed at the same time in connection therewith. (See section 273 (e).)

After a jeopardy assessment has been made, the list showing such assessment will be immediately transmitted to the collector. Upon receipt of the list containing the assessment, the collector is required to send notice and demand to the taxpayer for the amount of the jeopardy assessment. Regardless of whether the taxpayer has filed a petition with the Board, he is required to notify the Board of such assessment or abatement, and the Board has jurisdiction to determine the amount of the deficiency together with all other amounts assessed at the same time in connection therewith. (See section 273 (e).)

Art. 273-1. Jeopardy assessments—If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he is required to assess such deficiency immediately, together with the interest and other additional amounts provided by law. If a deficiency is assessed on account of a jeopardy assessment, after a decision of the Board of Tax Appeals is rendered, the jeopardy assessment may be made only with respect to the deficiency determined by the Board. The Commissioner is prohibited from making a jeopardy assessment after a decision of the Board has become final (see section 1005 of the Revenue Act of 1926, paragraph 16 of the Appendix to these regulations) or after the taxpayer has filed a petition for review of the decision of the Board.

If notice of a deficiency was mailed to the taxpayer (see section 272 (a)) before jeopardy notice and demand, the taxpayer is required to notify the Board of such assessment or abatement, and the Board has jurisdiction to determine the amount of the deficiency together with all other amounts assessed at the same time in connection therewith. (See section 273 (e).)
and demand, there shall be collected as part of the tax, interest as provided in section 294 (b). If the amount of the deficiency is in excess of the amount determined by the Board, the unpaid part of the deficiency shall 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 bankruptcy cases, see sections 274 and 298 and articles 274-1 and 274-2.

Sec. 274. Bankruptcy and receiverships.—
(a) Immediate assessment.—Upon the adjudication of bankruptcy of any taxpayer in any bankruptcy or 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 an immediately preceding proceeding in which such taxpayer was a party, if a notice of the deficiency was not theretofore been assessed in accordance with law, in such proceeding do not
(b) Unpaid claims.—Any portion of the claim against a taxpayer in any bankruptcy or receivership proceeding which is unpaid shall be paid by the taxpayer upon notice and demand made after the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver to a date 90 days after the date upon which the notice of the deficiency was received by the Commissioner; but the suspension under this sentence shall in no case extend in excess of two years. Claims for the deficiency and such interest, additional amounts and additions to the tax are payable in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver.

Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended (paragraphs 47 and 48 respectively of the Appendix to these regulations), and section 64 of the Bankruptcy Act, as amended, taxes are entitled to the priority of other taxes then in the order of their infancy. In no case shall the claim of the United States for taxes be collected with interest as provided in section 74 or 76 or Chapter X of such Act, as amended; and the term "adjudication of bankruptcy" includes, in addition to an adjudication under chapter XI to VII, the approval of a petition as properly filed under section 77 or 77T or Chapter X by a court of competent jurisdiction on the filing of a petition under section 74 or 75 or Chapters XI to XXII with a court of competent jurisdiction.

A trustee in bankruptcy (including a trustee, receiver, debtor in possession, or other person designated as in control of the assets of a debtor in any bankruptcy proceeding by order of the court in which such proceeding is pending) or a receiver in any receivership proceeding is required to give notice in writing to the Commissioner of Internal Revenue in Washington, D.C., of the adjudication of bankruptcy or the appointment of a receiver. (See section 274 (a) and article 274-1.)

Section 274 should, promptly after notice of outstanding liability against a taxpayer in any bankruptcy or receivership proceedings, and in any event within the time limited by the appropriate provisions of the Bankruptcy Act, as amended, and the orders of the court in which such proceeding is pending, file a claim covering such liability in the court in which such proceeding is pending. Such claim shall be filed whether the unpaid taxes involved have been assessed or not, except in cases where the departmental instructions direct otherwise; for example, where the payment of the taxes is secured by a sufficient bond. Such claim shall cover the amount represented by the assessment, plus interest at the rate of 6 percent per annum for the period from the date of adjudication of bankruptcy or receivership or the appointment of the receiver to a date 90 days after the date upon which the notice of the deficiency is received by the Commissioner; but the suspension under this sentence shall in no case extend in excess of two years. Claims for the deficiency and such interest, additional amounts and additions to the tax are payable in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver.

(b) Unpaid claims.—Any portion of the claim against a taxpayer in any bankruptcy or receivership proceeding which is unpaid shall be paid by the taxpayer upon notice and demand made after the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver.

Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended (paragraphs 47 and 48 respectively of the Appendix to these regulations), and section 64 of the Bankruptcy Act, as amended, taxes are entitled to the priority of other taxes then in the order of their infancy. In no case shall the claim of the United States for taxes be collected with interest as provided in section 74 or 76 or Chapter X of such Act, as amended; and the term "adjudication of bankruptcy" includes, in addition to an adjudication under chapter XI to VII, the approval of a petition as properly filed under section 77 or 77T or Chapter X by a court of competent jurisdiction on the filing of a petition under section 74 or 75 or Chapters XI to XXII with a court of competent jurisdiction.

A trustee in bankruptcy (including a trustee, receiver, debtor in possession, or other person designated as in control of the assets of a debtor in any bankruptcy proceeding by order of the court in which such proceeding is pending) or a receiver in any receivership proceeding is required to give notice in writing to the Commissioner of Internal Revenue in Washington, D.C., of the adjudication of bankruptcy or the appointment of a receiver. (See section 274 (a) and article 274-1.)

Section 274 should, promptly after notice of outstanding liability against a taxpayer in any bankruptcy or receivership proceedings, and in any event within the time limited by the appropriate provisions of the Bankruptcy Act, as amended, and the orders of the court in which such proceeding is pending, file a claim covering such liability in the court in which such proceeding is pending. Such claim shall be filed whether the unpaid taxes involved have been assessed or not, except in cases where the departmental instructions direct otherwise; for example, where the payment of the taxes is secured by a sufficient bond. Such claim shall cover the amount represented by the assessment, plus interest at the rate of 6 percent per annum for the period from the date of adjudication of bankruptcy or receivership or the appointment of the receiver to a date 90 days after the date upon which the notice of the deficiency is received by the Commissioner; but the suspension under this sentence shall in no case extend in excess of two years. Claims for the deficiency and such interest, additional amounts and additions to the tax are payable in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver.

(b) Unpaid claims.—Any portion of the claim against a taxpayer in any bankruptcy or receivership proceeding which is unpaid shall be paid by the taxpayer upon notice and demand made after the bankruptcy or receivership proceeding is pending, despite the pendancy of proceedings for the redetermination of the deficiency in pursuance of a petition to the Board; but no petition for any such redetermination shall be filed with the Board after the date of adjudication of bankruptcy or receivership or the appointment of the receiver.
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 6651, is due and payable at any time within four years after the return was filed.

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.

Sec. 276. -Corporation and shareholder. - If a corporation makes a return of the tax imposed by this title, each of the shareholders included in his return is distributable share of the undistributed Supplement P net income of a foreign personal holding company, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun, at any time within four years after the return was filed.

(b) False return or no return. - In the case of income received during the lifetime of a decedent, by his estate during the period of administration, or by a corporation, the tax shall be assessed, and any proceeding in court 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 any fiduciary representing the estate of such decedent or 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) Collection after assessment. - Where the tax is assessed at any time within two years after the return was filed, and within six years after the return, the amount of tax shall be assessed in court, for the collection of such tax may be begun without assessment, at any time.

Sec. 277. -Suspension of running of statute. - The 18-month period of limitation provided in section 276 or 276 on the making of assessments and the beginning of district cases or a proceeding in court for the collection of such tax shall be suspended for any 18-month period after the return was filed, if it is desired to take advantage of the provisions of section 278. In the case of a corporation the 18-month period of limitation shall not apply unless:

(a) The written request notifies the Commissioner that the corporation contemplates dissolution at or before the expiration of such period, and
(b) The collection is in good faith begun before the expiration of such period, and
(c) The dissolution so begun is completed either before or after the expiration of such 18-month period.

Such a request does not have the effect of extending the regular period of limitation even though the request is made less than 18 months before the expiration of the regular period of limitation.

If a corporation makes no income tax return under the Act, but each of the shareholders includes in his personal return his distributive share of the net income of the corporation, the tax of the corporation shall be assessed within four years after the last date on which any such shareholder's return was filed.

In case of income received after the return is filed.

In the event the taxpayer fails to file a return, the amount of tax due may be assessed at any time after such false or fraudulent return is filed.

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, the tax may be assessed at any time.

If 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.

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, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun, at any time within four years after the return was filed.

(1) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation contemplating dissolution, the tax shall be assessed within 18 months after written request therefor by the fiduciary or legal representative of the estate of the decedent or by the corporation, but not after the expiration of 3 years after the return was filed.

The effect of this provision is to permit the personal holding company to make a proper return and assessment of tax within 18 months after the return was filed, and not after the expiration of 3 years after the return was filed, and not after the expiration of 3 years after the return was filed, and not after the expiration of 3 years after the return was filed.

If the taxpayer omits from gross income an amount properly includible therein under section 301 (b) as an income tax imposed by the Act must be assessed within 18 months after written request therefor by the fiduciary or legal representative of the estate of the decedent or by the corporation, but not after the expiration of 3 years after the return was filed.

The effect of this provision is to permit the personal holding company to make a proper return and assessment of tax within 18 months after the return was filed, and not after the expiration of 3 years after the return was filed, and not after the expiration of 3 years after the return was filed, and not after the expiration of 3 years after the return was filed.

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, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun, at any time within four years after the return was filed.

If the event the taxpayer fails to file a return, the amount of tax due may be assessed at any time after such false or fraudulent return is filed.

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, the tax may be assessed at any time.
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.

(9) If before the expiration of the time prescribed in section 274 the Commissioner mails to a taxpayer a notice of deficiency within 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. Such a request does not suspend the running of the period of limitation after assessment stated in the preceding paragraph are as follows:

(1) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation, a proceeding in court for the collection of the tax without assessment must be begun within three years after the return was filed.

(2) A proceeding in court for the collection of the tax without assessment may be begun at any time:

(a) In case the taxpayer files a false or fraudulent return with intent to evade tax; and

(b) In case the taxpayer failed to file a return.

(3) If there is omitted from the gross income stated in the return an amount properly includible therein which is in excess of 25 percent of the gross income so stated, a proceeding in court for the collection of the tax may be begun without assessment at any time within five years after the return was filed.

(4) If the taxpayer omits from gross income an amount properly includible therein under section 337 but as his distributive share of the undistributed supplement P net income of a foreign personal holding company, a proceeding in court for the collection of the tax may be begun without assessment at any time within seven years after the return was filed.

In any case in which the tax has been assessed within the statutory period of limitation properly applicable thereto, a taxpayer before the expiration of the period 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, the tax may be assessed at any time within the prescribed time is shown to the satisfaction of the Commissioner to be due to reasonable cause and not due to willful neglect, there is added to the tax so added shall be collected at the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 percent excise tax so added to the tax provided in section 876 of the Revised Statutes, as amended.

Arr. 291-1. Addition to the tax in case of failure to make a return.—In case of failure to make a return as required by Title I within the prescribed time, a tax of six percent if the failure is for not more than 30 days, with an additional 5 percent for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate. The amount added to the tax shall be collected in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 percent excise tax so added to the tax provided in section 876 of the Revised Statutes, as amended.
tional 30 days or fraction thereof during which failure continues, not to exceed 25 percent in the aggregate. Two classes of delinquents are subject to this addition to the tax:

(a) Those who do not file returns and for whom returns are made by a collector, a deputy collector, or the Commissioner, and

(b) Those who file tardy returns and are unable to show reasonable cause for the delay.

A taxpayer who files a tardy return and wishes to avoid the addition to the tax for delinquency must make an affirmative showing of all facts alleged as a reasonable cause for failure to file the return on time in the form of an affidavit which should be attached to the return. If such an affidavit is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the Commissioner, will forward the affidavit with the return, and, if the Commissioner determines that the delinquency was due to something other than 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 false statements or failure to furnish the return, see section 3176 of the Revised Statutes, as amended (paragraph 65 of the Appendix to these regulations).

Sec. 292. Interest on deficiencies.—Interest upon the amount determined as a deficiency shall be charged from the date the deficiency is assessed or demanded, or, in case of a warrant under section 272 (d), from the thirtieth day after the filing of said warrant or to the date the deficiency is assessed whichever is the earlier.

Sec. 293. Additions to the tax in case of delinquency.—Negligence.—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations without intent to defraud, 5 per cent 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 cent addition to the tax provided in section 3176 of the Revised Statutes, as amended.

Sec. 294. Additions to the tax in case of nonpayment.—(a) Tax shown on return.—If the tax shown by the return is less than the tax determined by the Commissioner, the deficiency (including interest or additional amounts assessed in addition thereto under section 293, or any addition to the tax in case of delinquency provided for in section 291, 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 cent per annum from the date of such notice and demand, and the amount of the tax due, together with all interest thereon determined under section 293, 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 cent per annum from the date prescribed for its payment until it is paid.

(b) Deficiency.—Where a deficiency, or any interest or additional amounts assessed in addition thereto, is not determined as a deficiency, or any installment thereof, has been granted, and the amount due and payable for the time of the payment of such deficiency is not assessed, collected, and paid, the interest thereon determined under section 293 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 cent 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 of the deficiency provided for in subsection (a) or under section 293, or any addition to the tax in case of delinquency provided for in section 291, 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 cent per annum from the date of such notice and demand until it is paid. If the tax, or a part thereof, is not paid within ten days from the date of notice and demand from the collector, there shall be collected as a part of the tax interest upon the unpaid portion thereof at the rate of 6 per cent 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 by such manner as to hinder collection of the tax, see section 140.

CHAPTER XXXII

Claims Against Transferees and Fiduciaries

Supplement N—Claims Against Transferees and Fiduciaries

Sec. 311. Transferred assets.—(a) Method of collection.—The amounts of any such liabilities shall be collected in the following manner. For all purposes of this section, the provisions and limitations as in the case of a deficiency in a tax imposed by this title, and the provisions of section 274, as in the case of delinquency in payment after notice and demand, the provisions authorizing the filing of suits in court for the recovery of unpaid taxes and the provisions prohibiting claims and suits for refunds:

(1) Transferees.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this title.

(2) Fiduciaries.—The liability of a fiduciary under section 3467 of the Revised Statutes in respect of the payment of any such tax from the estate of the taxpayer.

Any such liability may be either as to the amount of the deficiency or as to any deficiency in tax.

(b) Period of limitation.—The period of limitation for assessment of the 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 the property of the taxpayer—within one year after the expiration of the period of limitation for assessment against the predecessor in interest of the transferee, if, by reason of the transfer of the property, the liability has been transferred to, or assumed by, the transferee.

(3) In 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 the extension of the period previously agreed upon. The period so agreed upon may be extended by subsequent agreement 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 372 (a), be suspended for the period during which the Commissioner is prevented from assessing the assessment in respect of the liability of the transferee or fiduciary (and in any event, if such suspended period of limitation or period so agreed upon is extended by subsequent agreement in writing made before the expiration of the period previously agreed upon).

(e) Address for notice of liability.—In the absence of notice to the Commissioner under section 312 (b) of the Revised Statutes, until notice of such transferee or fiduciary, the notice of liability enforceable under this section against the personal estate of the transferee or fiduciary shall be sufficient notica to the Commissioner that any person is acting in a fiduciary capacity for a person subject to the liability specified in section 311, such notice to be sufficient for the purposes of the Act, if mailed to such transferee or to such fiduciary (and in any event, if such suspended period of limitation or period so agreed upon is extended by subsequent agreement in writing made before the expiration of the period previously agreed upon).

(f) Definition of “transferee”.—As used in this section, “transferee” includes 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, the assignee of personal property or the personal representative of the personal estate of the transferee or fiduciary, not later than one year after the expiration of the period of limitation for assessment against the taxpayer (see sections 275-277);

(2) In the case of the liability of a transferee of a transferee of the property of the taxpayer, one year after the expiration of the period of limitation for assessment against the preceding transferee, or three years after the expiration of the period of limitation for assessment against the taxpayer, whichever of the two periods (the 1-year period or the 3-year period) is longer.

(3) If a court proceeding against the taxpayer or last preceding transferee for the collection of the tax or liability in respect thereof, respectively, has been begun within the period of limitation for the bringing of such proceeding, then the time within one year after the return of execution in such proceeding; and

(4) In the case of the liability of a fiduciary, not later than one year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is the later.

(5) If before the expiration of the time prescribed in section 372 (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 extension of the period previously 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 agreed upon, but the period so agreed upon shall be extended to 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 372 (a), then the running of the period 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 such suspended period of limitation or period so agreed upon is extended by subsequent agreement in writing made before the expiration of the period previously agreed upon).

Sec. 322. Notice of fiduciary relationship.—

(a) Fiduciary of taxpayer.—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, such notice to be sufficient for the purposes of the Act, except as herein specified, assume 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.

(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, such notice to be sufficient for the purposes of the Act, except as herein specified, assume 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.

Sec. 321. 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 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.

Art. 311-1. 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 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.
due from the taxpayer, and any balance shall be excess-profits tax or installment thereof then credited against any income, war-profits, or made, however, after the expiration of the amount of such overpayment shall be overassessment may not be allowed or of the tax, the overpayment shall be credited against the unpaid installments, if any. If the taxpayer has paid as an installment Section 321. Overpayment found by Board.—If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of the tax for the taxable year in respect of which the Commissioner determined that such overpayment was allowed or made and is not due to the recovery of any part of such tax, the Board shall be conclusively determined as part of its decision that such
portion was paid (1) within three years of the mailing of the notice of deficiency and (2) after the mailing of the notice of deficiency, no refund or credit will be . The amount of the credit or refund shall be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund. With respect to limitations upon the refunding or crediting of taxes, see article 322-7.

If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or any 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 as such and that the fiduciary 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 request of the agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in cases of credits or refunds, see section 614 of the Revenue Act of 1928, as amended by section 804 of the Revenue Act of 1932 (paragraph 43 of the Appendix to these regulations), and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936 (paragraph 43 of the Appendix to these regulations).

Art. 322-3. Claims for refund by taxpayers. Claims by the fiduciary 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, or other fiduciary acting in any fiduciary capacity for any person, for a claim for refund. With respect to limitations upon the refunding or crediting of taxes, see article 322-7.

If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or any other fiduciary files a return and thereby 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 as such and that the fiduciary 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 request of the agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in cases of credits or refunds, see section 614 of the Revenue Act of 1928, as amended by section 804 of the Revenue Act of 1932 (paragraph 43 of the Appendix to these regulations), and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936 (paragraph 43 of the Appendix to these regulations).

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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 any other fiduciary files a return and thereby 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 as such and that the fiduciary 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 request of the agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in cases of credits or refunds, see section 614 of the Revenue Act of 1928, as amended by section 804 of the Revenue Act of 1932 (paragraph 43 of the Appendix to these regulations), and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936 (paragraph 43 of the Appendix to these regulations).

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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 any other fiduciary files a return and thereby 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 as such and that the fiduciary 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 request of the agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in cases of credits or refunds, see section 614 of the Revenue Act of 1928, as amended by section 804 of the Revenue Act of 1932 (paragraph 43 of the Appendix to these regulations), and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936 (paragraph 43 of the Appendix to these regulations).
the necessary documentary evidence should accompany the claim. The affidavit may be made by the agent of the person assessed, but in such case a power of attorney must accompany the claim.

Checks in payment of claims allowed will be drawn in the names of the persons entitled to the money and may be sent to such persons in care of an attorney or agent who has filed a power of attorney specifically authorizing him to receive such checks. The Commissioner may, however, send any such check direct to the claimant. In this connection, see section 3477 of the Revised Statutes, which provides:

Sec. 3477. All transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders, or other authorities for receiving payment of any such claim, or of any part or share thereof, shall be absolutely null and void, unless they are freely made and executed in the presence of at least two witnesses, and are signed by the person making them, before an officer having authority to take acknowledgments of deeds and shall be acknowledged by the person making them, before an officer having authority to take acknowledgments of deeds and shall be acknowledged by the person making them, before an officer having authority to take acknowledgment. The Commissioner explained the transfer, assignment, or warrant of attorney to the person acknowledging the same.

The Commissioner has no authority to refund on equitable grounds penalties or other amounts legally collected. As to claims for refund of sums recovered by suit, see articles 322-4 to 322-6.

Art. 322-4. Claim for payment of judgment obtained against collector.—
(a) A claim for the amount of a judgment against a collector of internal revenue for the recovery of taxes, penalties, or other sums should be made in the usual manner, 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, received 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 a certificate of the 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 paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury.

If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

(b) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name, accompanied by two certified copies of the final judgment, and an itemized bill of the court costs paid. A certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, should accompany the claim. (See further article 322-3.)

Art. 322-5. Claim for payment of judgment obtained in United States district court against the United States.—A claim for the payment of a judgment rendered by a United States district court against the United States representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment should be attached to the claim. If the judgment specifically provides for the recovery of costs, an itemized bill of the court costs paid, received by the clerk of the court, should also accompany the claim. If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

Art. 322-6. Claim for payment of judgment obtained in the Court of Claims against the United States.—A claim for the payment of a judgment rendered by the United States Court of Claims against the United States representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C., accompanied by a certificate of judgment issued by the clerk of the court and two copies of the printed opinion of the court, if an opinion was rendered. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

Art. 322-7. Limitations upon the crediting and refunding of taxes paid.—(a) Unless a claim for credit or refund is filed within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, the Commissioner is prohibited from allowing or making a credit or refund of income tax imposed by Title I after both periods have expired. If no return is filed by the taxpayer, the Commissioner is prohibited from allowing or making a credit or refund of such tax after two years from the time the tax was paid unless before the expiration of such 3-year period a claim therefor is filed. The amount of the credit or refund in any case shall not exceed the portion of the tax paid during the 3-year period immediately preceding the date of the allowance of the credit or refund. If the credit or refund is based upon a claim, the amount of the credit or refund shall not exceed the portion of the tax paid during the 3-year period immediately preceding the date of filing such claim. The provisions of this paragraph are subject to the exceptions provided in paragraph (b) of this article.

(b) In any case where a person having a right to file a petition with the Board of Tax Appeals with respect to a deficiency in income tax imposed by the Act files such petition within the prescribed time, no credit or refund of the tax for the year to which the deficiency relates shall be allowed or made, and no suit for the recovery of any part of such tax shall be instituted by the taxpayer, except that—

(1) If the Board finds that there is no deficiency but that the person has overpaid his tax for the year to which the notice of deficiency relates, and if the decision of the Board as to the amount of such overpayment has become final (see section 1605 of the Revenue Act of 1926), the overpayment shall be credited or refunded, but no such credit or refund shall be made of any portion of the tax unless the Board determines as part of its decision that such portion was paid (A) not earlier than three years before the filing of the refund claim therefore or the filing of the petition, whichever event occurs first in point of time, or if no claim is filed, not earlier than three years before the filing of the petition, or (B) after the mailing of the notice of deficiency.

(2) In the case of a jeopardy assessment made under section 273, if the amount which should have been assessed as determined by a decision of the Board
which has become final is less than the amount already collected, the excess payment shall be credited or refunded subject to a determination being made by the Board with respect to the time of payment as stated in (b) (1) of this article.

(3) If the amount of the deficiency determined by the Board, or any deficiency where collection has not been stayed by the filing of a bond, is disallowed in whole or in part by the reviewing court, then the overpayment resulting from such disallowance shall be credited or refunded without the making of claim therefor subject to a determination being made by the Board with respect to the time of payment as stated in (b) (1) of this article. (See section 1001 (d) of the Revenue Act of 1926, as amended, paragraph 13 of the Appendix to these regulations.)

(4) Where the amount collected is in excess of the amount computed in accordance with the decision of the Board which has become final, the excess payment shall be credited or refunded within the period of limitation provided in section 322 (b). (5) Where an amount is collected after the statutory period of limitation upon the beginning of distraint or a proceeding in court for collection has expired (see article 275-2), the taxpayer may file a claim for refund of the amount collected within the period of limitation provided in section 322 (b). In any such case, the decision of the Board as to whether the statutory period upon collection of the tax expired before notice of the deficiency was mailed shall, when the decision becomes final, be conclusive.

Ann. 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 3216 of the Revised Statutes, may authorize him to take credit temporarily with respect to the assessments not specifically paid. Such action, however, shall not constitute an abatement and shall not discharge the liability of the persons concerned.

[Chapters XXXIV-XXXVIII and the Appendix will appear in the "Federal Register" for Tuesday, February 14, 1939.]

[Seal] GUY T. HELVERING,
Commissioner of Internal Revenue.
Approved: February 7, 1939.
H. MORGENTHAU, Jr.,
Secretary of the Treasury.

[F. R. Doc. 30-450; Filed, February 7, 1939; 4:01 p.m.]

**TITLE 30—MINERAL RESOURCES**

**NATIONAL BITUMINOUS COAL COMMISSION**

[General Docket No. 15]

**ESTABLISHMENT OF MINIMUM PRICES AND MARKETING RULES AND REGULATIONS**

**CORRECTION OF ERRORS IN SCHEDULES OF APPROVED MINIMUM PRICES FOR DISTRICTS NO. 7 AND 8**

**Order**

It appearing that in the schedule of minimum prices approved by the Commission for District No. 7, being the Appendix to the Findings of the Commission in the above-entitled matter, the coal of the Carter Coal Company in Size Group #5 produced at the Caretta #5 Mine, #4 Sub-district, in the War Creek Seam, by reason of a typographical error, was classified as “A” instead of Class “D,” as originally proposed by the Board and as found by the Commission, and

It further appearing that in the schedule of minimum prices approved by the Commission for District No. 8, being the Appendix to the Findings of the Commission in the above-entitled matter, the coal of the Carter Coal Company in Size Group #5 produced at the Caretta #5 Mine, #4 Sub-district, in the War Creek Seam, by reason of a typographical error, was classified as “G” instead of “J” as the same was modified by the Commission in its Findings entered herein, and

It further appearing that in said schedule of minimum prices for District No. 8, the coal of the Ajax Coal Company in Size Groups 21 to 25, both inclusive, were classified as “K” instead of “L,” as modified by the Commission in its Findings, and

It further appearing that in the said schedule of minimum prices for District No. 7, the coal of the Red Jacket Coal Corporation in Size Group 26, by reason of typographical errors, were given no classification, although the Commission found that these coals should be classified as follows: Mitchell Branch Mine, “J”; Junior Mine, “K”; #5 Mine, “N”; #6 Mine, “F”; #32 Top Mine, “M”; #32 Bottom Mine, “K.”

**Now, therefore,** it is ordered that the schedule of minimum prices approved by the Commission for District No. 7, to serve as the basis for coordination, be and the same hereby corrected by changing the classification therein appearing for Size Group 5 of the Caretta Mine of the Carter Coal Company from Class “A” to Class “D,” and

It is further ordered that the schedule of minimum prices approved by the Commission for District No. 8, to serve as a basis for coordination, be corrected in the following respects:

- The classification of the West Virginia Coal and Coke Corporation’s Earlying Mine in Size Group 26 be and the same is hereby changed from “G” to “J.”

The classification of Size Groups 21 to 25, both inclusive, produced at the Ajax Company of the Ajax Coal Company, be and the same are hereby changed from Classification “K” to Classification “L.”


The Secretary of the Commission is hereby directed to cause a copy of this Order to be included in the docket containing the record of the proceedings in the matter of the proposal of minimum prices by the District Boards for Districts Nos. 7 and 8 in General Docket No. 15, and shall cause a copy of this Order to be published forthwith in the Federal Register, and shall cause a copy hereof to be mailed to the Secretary of each District Board, to each code member in Districts Nos. 7 and 8, to the Consumers’ Counsel, and to all parties who have filed their appearances in the hearing relating to the proposals submitted by the District Boards for Districts Nos. 7 and 8, and shall cause a copy hereof to be made available for inspection at the office of the Secretary of the Commission, Washington, D. C., and at the office of each Statistical Bureau of the Commission.

By order of the Commission.

Dated this 8th day of February, 1939.

[Seal] F. W.ITCHEN MCCULLOUGH,
Secretary.

[F. R. Doc. 32-463; Filed, February 10, 1939; 10:05 a.m.]

**NOTICES**

**DEPARTMENT OF THE INTERIOR.**

National Bituminous Coal Comission.

[Doc. No. 4-1939]

**APPLICATION OF SMOKELESS COAL CORPORATION FOR PROVISIONAL APPROVAL AS MARKETING AGENCY**

**PETITION FOR APPROVAL OF CHANGES IN FORMS OF CONTRACTS BETWEEN THE CORPORATION AND PRODUCERS AND SUB-AGENTS**

**Notice and Order for Hearing**

The petitioner above-named, having on the 25th day of January, 1939, filed its petition for approval of changes in forms of contracts between the corporation and producers and sub-agents, Notice is hereby given that the above-entitled matter is assigned for hearing before an Examiner of the Commission on the 1st day of March, 1939, at ten o’clock a. m., at the hearing room of the Commission, Walker Building, 134 15th Street, N. W., Washington, D. C., at which time and place interested parties will be afforded an opportunity to be heard.
Rules, Regulations, Orders

TITLE 14—CIVIL AVIATION

CIVIL AERONAUTICS AUTHORITY

[Amendment 4]

AMENDMENT OF REGULATION 601-A-1 OF THE CIVIL AIR REGULATIONS RELATIVE TO EQUIPMENT

At a session of the Civil Aeronautics Authority held at its office in Washington, D.C., on the 10th day of February 1939.

Acting pursuant to the authority vested in it by the Civil Aeronautics Act of 1938, particularly Sections 205 (a) and 601 (a) of said Act, and finding that its action is desirable in the public interest and is necessary to carry out the provisions of, and to exercise and perform its powers and duties under said Act, the Civil Aeronautics Authority hereby amends the Civil Air Regulations as follows:

[Amendment No. 4 of Civil Air Regulations]

REQUIRING A MANUFACTURER’S AIRCRAFT OPERATING MANUAL WHEN REQUIRED BY THE APPROVED TYPE CERTIFICATE OR TYPE CERTIFICATE TO BE CARRIED IN THE AIRCRAFT AT ALL TIMES

Sec. 04.5 of the Civil Air Regulations is hereby amended by adding at the end thereof a new subsection 04.504:

"04.504 A manufacturer’s aircraft operating manual, when required by the approved type certificate, type certificate, or approved specification which is part thereof, and when such manufacturer’s aircraft operating manual has been approved by the Authority, shall be carried in the pilots’ compartment at all times."

For the Authority:

[ SEAL]    PAUL J. FRENZEL,
           Secretary.


TITLE 16—COMMERCIAL PRACTICES

FEDERAL TRADE COMMISSION

IN THE MATTER OF PHILIP MORRIS & CO., LTD., INC.

Sec. 3.99 (b) Using or selling lottery devices—In merchandising. Selling, etc., in connection with offer, etc., in interstate commerce or in District of Columbia, of cigarettes or any other merchandise, together with punch boards or other lottery devices which are to be, or may be, used in selling, etc., such cigarettes, etc., to the public, prohibited. (Sec. 5b, 52 Stat. 112; 15 U. S. C., Supp. IV, sec. 45b) [Cease and desist order, Philip Morris & Co., Ltd., Inc., Docket 3296, January 31, 1939]

Sec. 3.99 (b) Using or selling lottery devices—In merchandising. Selling, etc., dealers, in connection with offer, etc., in interstate commerce or in District of Columbia, of cigarettes or any other merchandise, together with punch boards or other lottery devices which are to be, or may be, used in selling, etc., such cigarettes, etc., to the public, prohibited. (Sec. 5b, 52 Stat. 112; 15 U. S. C., Supp. IV, sec. 45b) [Cease and desist order, Philip Morris & Co., Ltd., Inc., Docket 3296, January 31, 1939]

Sec. 3.99 (b) Using or selling lottery devices—In merchandising. Selling, etc., dealers, in connection with offer, etc.,

CONTENTS

RULES, REGULATIONS, ORDERS

TITLE 14—CIVIL AVIATION

Civil Aeronautics Authority: Page

Civil Air Regulations amended (equipment) 797

TITLE 16—COMMERCIAL PRACTICES

Federal Trade Commission:

Cease and desist orders:

Enduro Corp. 793

Knox Co. 799

Moretrench Corp. 809

Philip Morris & Co., Ltd., Inc. 797

TITLE 17—COMMODITY AND SECURITIES EXCHANGES

Securities and Exchange Commission:

Securities Act of 1933, amendment of Rule S-12. (Sale of copies of registered information) 801

TITLE 18—CUSTOMS DUTIES

Bureau of Customs:

Mail articles received in damaged condition or short of contents 601

TITLE 26—INTERNAL REVENUE

Bureau of Internal Revenue:

Income tax under the Revenue Act of 1933 (Regulations 101):

Chapter XXXIV—Foreign personal holding companies 812

Chapter XXXV—Mutual investment companies 813

(Continued on next page) 797
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CHAPTER XXXIV

Foreign Personal Holding Companies

Supplement P—Foreign Personal Holding Companies

Sec. 331. Definition of foreign personal holding company.—(a) General rule.—For the purposes of this title the term "foreign personal holding company" means any foreign corporation if—

(1) Gross income requirement.—At least 60 per centum of its gross income (as defined in section 332) for the taxable year is foreign personal holding company income as defined in section 332; but if a corporation is designated as a personal holding company with respect to any taxable year ending after August 26, 1937, then the subsequent 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 the gross income is foreign personal holding company income. For the purposes of this paragraph there shall be included in the gross income the amounts includable 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 60 per centum in value of its outstanding stock is owned, directly or indirectly, by for not more than five individuals who are citizens or residents of the United States, hereinafter called "United States group".

(b) Exceptions.—The term "foreign personal holding company" does not include a corporation exempt from taxation under section 101.

Art. 331-1. Definition of foreign personal holding company.—A foreign personal holding company is any foreign corporation (other than a corporation exempt from taxation under section 101) which for the taxable year meets (a) the gross income requirements specified in article 331-2, and (b) the stock ownership requirement specified in article 331-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

A foreign corporation which comes within the classification of a foreign personal holding company for any taxable year beginning after December 31, 1937, is not subject to taxation for such taxable year either under section 102 or section 401 but may be subject to taxation under either of those sections for other taxable years. The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally under section 231 upon foreign corporations, since such taxes apply regardless of the classification of the foreign personal holding company.

Art. 331-2. Gross income requirement.—To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in 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 the regulations prescribed under that section.

Art. 331-3. Stock ownership requirement.—To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by for not more than five individuals who are citizens or residents of the United States, hereinafter referred to as "United States group." For such purpose, the ownership of the stock must be determined as provided in section 333 and articles 333 (a)–1 to 333 (a)–7 and article 333 (b)–1.

In the event of any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior thereto 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 by means of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return.

In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

Sec. 332. Foreign personal holding company income.—For the purposes of this title the term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1), which consists of:

(a) Dividends, interest, royalties, annuities.

(b) Stock and securities transactions.—Except in the case of regular dealers in stock and securities, gains from the sale or exchange of stock or securities.

(c) Commodity transactions.—Gains from the sale or exchange of futures transactions in any commodity exchange. This subsection applies regardless of whether the corporation has the right to designate (by name or by description) the individual who is to perform the 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) of a person other than the corporation, then for each taxable year the corporation has been classified as a foreign personal holding company and has been treated as if for such taxable year the corporation had the right to designate the individual who is to perform the services, 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 the property is held by the corporation for the personal use of the shareholder, or for the personal use of any person related to the shareholder, or for the personal use of any person connected with the corporation, or in any case where the property is held by the corporation as a holder of an option or as a representative of the corporation, if not subject to taxation under section 332.

Art. 332-1. Foreign personal holding company income.—For the purposes of this subsection 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 and securities, gains from the sale or exchange of stock or securities.

(c) Commodity transactions.—Gains from the sale or exchange of futures transactions in any commodity exchange. This subsection applies regardless of whether the corporation has the right to designate (by name or by description) the individual who is to perform the 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) of a person other than the corporation, then for each taxable year the corporation has been classified as a foreign personal holding company and has been treated as if for such taxable year the corporation had the right to designate the individual who is to perform the services, 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 the property is held by the corporation for the personal use of the shareholder, or for the personal use of any person related to the shareholder, or for the personal use of any person connected with the corporation, or in any case where the property is held by the corporation as a holder of an option or as a representative of the corporation, if not subject to taxation under section 332.
term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1) and article 331-2 which consists of the following:

(1) **Dividends.** The term "dividends" includes dividends as defined in section 119 (a) and amounts required to be included in gross income under section 334 (b). It does not include stock dividends (to the extent they do not constitute income to the shareholders within the meaning of the sixteenth amendment to the Constitution), liquidating dividends, or other capital distributions referred to in section 115 (c) and (d).

(2) **Interest.** The term "interest" means any amounts, includible in gross income, received for the use of money loaned.

(3) **Royalties.** The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not include rents, or overriding royalties received by an operating company. As used in this paragraph the term "overriding royalties" means amounts received from the sublessor by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

(4) **Annuities.** The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(5) **Gains from the sale or exchange of stock or securities.** The term "gains from the sale or exchange of stock or securities" as used in section 332 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 332 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Act), certificates of interest or participation in any profit-sharing agreement, or, in any oil, gas, or other mineral lease, royalty, or lease, collateral trust certificates, voting trust certificates, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a Government, State, Territory, or political subdivision thereof. In the case of "regular dealers in stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealers in stock or securities" as used in section 332 (b) means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporation is not required to deal with respect to stock or securities held for speculation or investment.

(6) **Gains from futures transactions in commodities.** Gains from futures transactions in commodities include gains from futures transactions in any commodity engaged in through a broker or over the floor of a board of trade or commodity exchange, but do not include gains from each transaction or gains by a producer, processor, merchant, or handler of the commodity, which arises 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 from futures contracts which are speculative transactions, including true hedges against price fluctuations in spot goods 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 current futures or forward sales or purchases.

(7) **Income from estates and trusts.** The income from estates and trusts which is to be included in foreign personal holding company income consists of the income from estates and trusts which is required to be included in the gross income of the corporation under sections 161 to 169, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) **Amounts received under personal service contracts.** Amounts includible in foreign personal holding company income as amounts received under personal service contracts consist of amounts received pursuant to a contract under which the corporation is to furnish personal services, and amounts received from a sale or other disposition of such a contract, if:

(a) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(b) at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description), as the one to perform such services. For this purpose the stock of which the right to be designated has been provided in section 333 and articles 333 (a)–1 to 333 (a)–7 and article 333 (b)–1.

The application of section 332 (e) may be illustrated by the following examples:

Example (1): A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation, a foreign corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons to 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 O Corporation was to pay the M Corporation $50,000 a year. The $50,000 received by the M Corporation from the O Corporation constitutes foreign personal holding company income.

Example (2): The N Corporation, a foreign corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute foreign personal holding company income.

(9) **Compensation for use of property.** The compensation for the use of, or the right to use, property of the corporation which is to be included in foreign personal holding company income consists of amounts received as compensation (however designated whenever 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, or a country house, or any other kind of property. See sections 331 (a) (2) and 333 and articles 333 (a)–1 to 333 (a)–7 and article 333 (b)–1.

(10) **Rents.** The rents which are to be included in foreign personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property, but do not include amounts constituting foreign personal holding company income under section "regular dealers in stock or securities" as defined in this section. However, rents do not constitute foreign personal holding company income.
come if constituting 50 percent or more of the gross income of the corporation.

Sec. 333. Stock ownership.—(a) Constructive ownership.—In determining whether a foreign corporation is a foreign personal holding company, in so far as such determination is based on 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 not 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 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 stock owned by a family personal holding company; and

(B) For the purposes of section 333 (e) (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.

(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 (3), 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.

(b) Options.—If stock may be considered as owned by an individual under either paragraph (a) or (b) of section 333 (a), the option to acquire stock may be considered as owned by him under paragraph (3).

Art. 333 (a) (1). Stock ownership.—For the purpose of determining whether—

(a) a foreign corporation is a foreign personal holding company, in so far as such determination is based on the stock ownership requirement specified in section 331 (a) (2) and article 333 (e), 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 (f) and paragraph (9) of article 332 (f) —

(c) compensation for the use of property constitutes foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (f) and paragraph (9) of article 332 (f).—

Stock owned by an individual includes stock constructively owned by him as provided in section 333. For such purposes constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 333 and articles 333 (a) (2) to 333 and articles 333 (a) (7) and Article 333 (b) (1). All forms and classes of stock shall be treated in an integrated manner, which is to represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

Art. 333 (a) (2). Stock not owned by individual.—In determining the ownership of stock for any of the purposes set forth in article 333 (a) (1), stock owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust for estate, and the trust 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 individual owning the beneficial interest therein. See also article 333 (a) (6).

Art. 333 (a) (3). Family and partnership ownership.—In determining the ownership of stock for any of the purposes set forth in article 333 (a) (1), 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 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 any of the purposes set forth in (a) of article 333 (a) (1) is illustrated by the following example:

Example: The M Corporation at some time during the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

<table>
<thead>
<tr>
<th>Relationships</th>
<th>Shares</th>
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<tbody>
<tr>
<td>A</td>
<td>100</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
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<tr>
<td>C</td>
<td>20</td>
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<td>D</td>
<td>20</td>
</tr>
<tr>
<td>E</td>
<td>20</td>
</tr>
<tr>
<td>F</td>
<td>20</td>
</tr>
</tbody>
</table>

By applying the statutory rule provided in section 333 (a) (2) five individuals own 90 percent of the outstanding stock as follows:

| A (including AP, AW, AB, AS, ASH, AP) | 100 |
| B (including AW, BB, BS, BSSB)        | 100 |
| C (including AB, CB, CS, CWS)         | 250 |
| D (including DB, DBW)                 | 200 |
| E (including EBW, EBWF, EBWDF)        | 170 |

By the application of the family rule as used in this article includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

Art. 333 (a) (4). Options.—In determining the ownership of stock for any of the purposes set forth in article 333 (a) (1), if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this article includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

Art. 333 (a) (5). Application of family-partnership and option rules.—The family and partnership rule provided in section 333 (a) (2) and article 333 (a) (3) and the option rule provided in section 333 (a) (4) shall be applied—

(a) for the purpose stated in (a) of article 333 (a) (1), if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company, or

(b) for the purpose stated in (b) of article 333 (a) (1), if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company.
amounts received under a personal service contract or from the sale of such a contract foreign personal holding company income, or
(e) for the purpose stated in (c) of article 333 (a)-1, if, but only if, the effect of such is to (i) toward the compensation for the use of property foreign personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in article 333 (a)-1.

Arr. 333 (a)-6. Constructive ownership as actual ownership.—In determining the ownership of stock for any of the purposes set forth in article 333 (a)-1—

(a) stock constructively owned by a person by reason of the application of the rule provided in section 333 (a) (1) relating to stock not owned by an individual (see article 333 (a)-2) shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 333 (a) (2) (see article 333 (a)-3) in order to make another person the constructive owner of such stock, and

(b) stock constructively owned by a person by reason of the application of the option rule provided in section 333 (a) (3) (see article 333 (a)-4) shall not be considered as actually owned by such person for the purpose of applying either the rule provided in section 333 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 333 (a) (2) in order to make another person the constructive owner of such stock, but

(c) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 333 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

The application of this article may be illustrated by the following examples:

Example (1): A is a United States citizen, whose wife, AW, owns all of the stock of the O Corporation. The O Corporation in turn owns all the stock of the O Corporation. The O Corporation in its turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation. Under the provision of 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 determine the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in article 333 (a)-1. But the stock thus constructively owned by AW may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make an- other 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. The stock of the R Corporation is considered as constructively owned by AW, B's wife, for the purpose of again applying the family and partnership rule in order to make another member of B's family, for example B's brother, the constructive owner of the stock of B 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 of B. (See article 333 (a)-6)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, AW may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under article 333 (a)-6, such constructive ownership by AW is considered 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 B 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) and article 333 (a)-6 shall 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.

Arr. 333 (a)-7. Option rule in lieu of family and partnership rule.—If, in determining the ownership of stock for any of the purposes set forth in article 333 (a)-1, stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 333 (a) (2) (see article 333 (a)-3) and the option rule provided in section 333 (a) (3) (see article 333 (a)-4) such stock shall be considered as constructively owned by the individual by reason of the application of the option rule.

The application of this article may be illustrated by the following example:

Example: Two brothers, A and B, each own 10 percent of the stock of the M Corporation, a foreign corporation, and A's wife, AW, also 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in article 333 (a)-1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family, (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 of B. (See article 333 (a)-6)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under article 333 (a)-6, such constructive ownership by AW is considered 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 B 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) and article 333 (a)-6 shall 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.
In 1939 or 1940, and those convertible in 1938, 1939, and the others are not so considered, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

**Note:**

- **Art. 333 (b)-1. Convertible securities.**—Under section 333 (b), outstanding securities of a foreign corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation at any date (whether or not 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 335 (a) (1) (C), relating to computation 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 only if those others are not so considered, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also so considered.

- **Art. 334-1. Gross income in general for purposes of Supplement P.**—For all purposes of Supplement P and Chapter XXXIV of these regulations, the gross income of a foreign corporation shall be computed as if the corporation were a domestic corporation and without regard to the provisions of Supplement I and Chapter XXXV of these regulations, relating to the taxation of foreign corporations generally. Hence, for such purposes, the gross income shall be computed 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 exclusion provided for in section 2 of the Fourth Liberty Bond Act of July 9, 1918, as amended by section 4 of the Victory Liberty Loan Act of March 3, 1919.

- **Art. 334-2. Additions to gross income for purposes of Supplement P.**—If, for any taxable year—
  - (a) a foreign corporation meets the stock ownership requirement specified in section 331 (a) (2) and 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 beginning before, on or after January 1, 1938, of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company on which the United States group exists with respect to the second company, then for the purpose of—
    - (c) determining whether the first company meets the gross income requirement specified in article 331-5, 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 the gross income of 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.

**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, as follows:

- **(1) determination as to come within the classification of a foreign personal holding company.**
  - The requirement in paragraphs (1) and (2) shall be applied in the case of every foreign corporation whose stock is properly considered as outstanding stock although 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 conversion date may be included although the others are not so considered.
  - Whether or not such other foreign personal holding companies would come within the exemption provided in section 334.

**Gross income of foreign personal holding companies.**—(a) General rule.—As used in the regulations with respect to a foreign corporation the term “gross income” means gross income computed (without regard to the provisions of Supplement P) at the foreign corporation's headquarters.

(b) Determinations to gross income.—In the case of a foreign personal holding company (whether or not a United States group, as defined in section 332 (c) (1) (A) exists with respect to such company on the last day of its taxable year) which was a shareholder in another foreign personal holding company on the day in the taxable year (whether beginning before, on or after January 1, 1938) of the second company which was the last day on which a United States group existed with respect to the second company, there shall be included in such gross income, 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 as to come within the classification of a foreign personal holding company, and

(c) Determining whether the first company meets the gross income requirement specified in article 331-5, so as to come within the classification of a foreign personal holding company.

**Example:** (1) The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1939, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts, the X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for the fiscal year ending June 30, 1939. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1939, if it also meets the gross income requirement.

For the purpose of determining whether the X Corporation meets the gross income requirement, the entire
undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1939, must be included as a dividend in the gross income of the X Corporation for 1939, since—

(a) the X Corporation was a shareholder in the Y Corporation on a day (June 30, 1939) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(b) such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

c) the X Corporation being the sole shareholder of the X Corporation must include such portion in its gross income for 1939, the taxable year in which or with which the taxable year of the Y Corporation ends.

If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1939, then the undistributed Supplement P net income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed Supplement P net income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed Supplement P net income of the Y Corporation is not includible in the gross income of the X Corporation.

Example (2): The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1939, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1940, more than the required percentage of the gross income of the Y Corporation consisted of the income of foreign personal holding company income. The net income of the Y Corporation for such fiscal year amounted to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1939. The undistributed Supplement P net income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1940, since at one time in such fiscal year, or from July 1 to and including September 30, 1939, it meets the stock ownership requirement, and the gross income requirement is also satisfied.

In determining whether the X Corporation constitutes a foreign personal holding company for 1940, a portion of the undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1940 (3/12 of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(a) the X Corporation was a shareholder in the Y Corporation on September 30, 1939, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(b) the portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

c) the X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1940, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed Supplement P net income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1939, the day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example (3): The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1939, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1940, no part of the undistributed Supplement P net income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1940, in determining whether the X Corporation is a foreign personal holding company for that year. The undistributed Supplement P net income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1939, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed.

If, however, the X Corporation sells 90 percent of its stock in the Y Corporation on a day (June 30, 1939) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation 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 in the Y Corporation is not 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 in which it is a majority shareholder, 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 X 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 event, 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 X 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 means, for the purposes of this section, the amount of the term "undistributed Supplement P net income" means the Supplement P net income (as defined in section 303) minus the amount
of the basic surtax credit provided in section 29 (b) (1), that is, the reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to income from obligations of the United States and Government corporations).

Sec. 336. Supplement P net income.—For the purposes of this title the term “Supplement P net income” means the net income with the following adjustments:

(a) Additional deductions.—There shall be allowed additional deductions:

(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, but not allowed under section 23; but not including the tax imposed by section 402, section 401, or section 400, annual excise taxes, and the tax on sales and gross receipts, if any, corresponding to each 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, 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 the preceding section, and without the inclusion in gross income of the amounts includible therein as dividends by reason of section 43 (b) (1), but allowing in full the deduction provided in section 334 (b) (relating to the inclusion in gross income of the amounts attributable to the dividends by reason of section 334 (b) (1) of the provision of this section).

(b) Deductions not allowed.—(1) Taxes and pension trusts.—The deductions provided in section 23 (a), relating to expenses, and section 23 (j), 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 (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

(A) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) That the property was held in the course of a business carried on bona fide for profit; and

(C) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

Art. 336-1. Supplement P net income.—The term “Supplement P net income” means the gross income as defined in section 334 less the deductions provided in section 23 (computed without regard to the provisions of Supplement P net income) to the qualification of limitations, and exceptions provided in section 336. In addition to the qualifications, limitations, and exceptions provided in section 336 (a) and section 336 (b) (1), under section 336 (b) (2) the following limitations and exceptions shall be applied under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit;

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of the undistributed Supplement P net income of a foreign personal holding company to be included in gross income in his individual return (see section 337 and article 337-1), claims deductions for expenses allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(a) A description of the property;

(b) The cost or other basis to the corporation and the nature, and value of the consideration paid for the property;

(c) The name and address of the person from whom acquired and the date thereof;

(d) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(e) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years, and the amount of the expenses incurred with respect to, and the depreciation claimed on, the property for such years;

(f) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(g) Any of the contract, lease or rental agreement;

(h) The purpose for which the property was used;

(i) The business carried on by the corporation with respect to which the property was held and the gross income, expenses and net income derived from the operation of such business for the taxable year and for each of the five preceding years;

(j) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(k) Any other information pertinent to the taxpayer's claim.

Art. 338-2. Illustration of computation of Supplement P net income and undistributed Supplement P net income.—The method of computation of the Supplement P net income and undistributed Supplement P net income may be illustrated as follows:

The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1938:

The gross income of the corporation as defined in section 334 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

The expenses of the corporation amount to $83,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder, and $8,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established, as provided in section 336 (b) (2). The yearly depreciation on the rented property amounts to $30,000.

Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $42,250.

No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets.

Contributions payment of which is made to or for the use of donees described in section 23 (q), for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing net income under section 21.

The following facts are 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 dis-
of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates and trusts (other than financial institutions) in which the United States shareholders own more than 50 percent in value of the outstanding stock of the company. Such United States shareholders (hereinafter called "United States shareholders") in the manner and to the extent prescribed by law for filing the return.

(b) Basis of stock in hands of shareholders.—The amount required to be included in the gross income of a United States shareholder under subsection (a) for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if any stock had been distributed) is treated as having been reinvested in the hands of the shareholder as a contribution to capital and the accumulated earnings and profits and the basis 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.

(d) Income of foreign personal holding companies taxed to United States shareholders.—(a) General rule.—Supplement P does not impose a tax on foreign personal holding companies. The undistributed Supplement P net income of such companies, however, must be included in the manner and to the extent set forth in this article, in the gross income of their "United States shareholders," that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships (see section 931), and estates or trusts other than estates or trusts the gross income of which under this title includes only income from sources within the United States.

(b) Amount includible in gross income.—Each United States shareholder, who was a shareholder in the foreign personal holding company which was the last day on which a United States group existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which such amount or any portion thereof is included in the gross income of the United States group, and its instrumentalities, any amount with respect to the unrelated Supplement P net income of such company, for the taxable year as the portion of such taxable year up to and including such day bears to such taxable year.

(c) Credit for obligations of United States and its instrumentalities.—Each United States shareholder shall be allowed a credit against net income, for the purpose of the tax imposed by sections 111, 113, 120, 123, 124, or 126, of his proportionate share of the interest specified in section 22 (a) (1) or (2) which is included in the gross income of the company otherwise than by the apportionment of the provisions of section 23 (b) relating to the inclusion in the gross income of a foreign personal holding company of its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder.

(d) Information in return.—Every United States shareholder who is required under subsection (b) to include in his gross income any amount with respect to the undistributed Supplement P net income of a foreign personal holding company 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 the foreign personal holding company had been a domestic corporation which was the last day on which a United States group existed with respect to it, and its instrumentalities, any amount with respect to the unrelated Supplement P net income of such company, for the taxable year as the portion of such taxable year up to and including such day bears to such taxable year.

The undistributed Supplement P net income of the foreign personal holding company is includable 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 of the undistributed Supplement P net income even though the domestic corporation can not be included within the United States group since, under section 333 (a) (1) and article 333 (a),-
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 preferred 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 next be treated as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation whose taxable year is the calendar year is a foreign personal holding company for 1938, and if A, one of its United States shareholders, makes return on a calendar year basis, while B, another United States shareholder, makes return on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1938, and B must return his assumed dividend as income for the fiscal year ending November 30, 1939.

In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1938, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1938, and A, who owned nonresident alien stock, would actually have assumed to have been made, does not fall within such fiscal year.

Art. 337-2. Credit for obligations of the United States.—Each United States shareholder required to return his distributive share in the undistributed Supplement P net income of a foreign personal holding company for any taxable year is allowed, for purposes of the tax imposed by sections 11, 13, 14, 201, 204, 207, or 352, a credit against his net income for his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in section 25 (a) (1) and (2)) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 334 (b) and article 334-2.

For example, the M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 25 (a) (1) and (2). In applying the credit allowable under section 337 (e), 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 forms part of the gross income of the M Corporation, as an actual dividend or as a constructive dividend under section 334 (b).

Art. 337-3. Information in return.—The information required by section 337 (d) in the returns of certain United States shareholders includes only the 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 returns required under the Act of such persons, in the form of a statement attached to the return.

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 1938 the M Corporation has an undistributed Supplement P net income of $100,000. A is required to include $75,000 of such income in gross income in his return for the calendar year 1938. The $100,000 is treated as paid-in surplus on a contribution to capital, the M Corporation has no accumulated earnings and profits as of the close of the calendar year 1938 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation would be entitled to a credit allowable under section 119 (a) (2) (B), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example (2): In example (1) assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1938, $75,000 as a constructive dividend from the M Corporation, the basis of his stock would be $375,000. After the $75,000 is distributed by the M Corporation tax-free the basis of A's stock, assuming no other changes, would again be $300,000. If A failed to include the $75,000 in gross income in his return for the calendar year 1938, the Act and his failure was not discovered until after the 7-year period of limitations had expired, the application of the rule would not increase the basis of A's stock.
$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 Corporation is in excess of 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 return. 

Sec. 338. Information returns by officers and directors.—(a) Monthly returns.—On the fifteenth day of each month which begins after the date of the enactment of this Act each individual who on such 15th day is an officer or a director of a foreign corporation which, with respect to its taxable year, the approval of the Secretary shall be prescribed as necessary for carrying out the provisions of this Act, shall file with the Commissioner a return setting forth with respect to its taxable year, the following information: 

1. Kind of business in which the corporation is engaged; 
2. The country under the laws of which the corporation is incorporated; 
3. Number of shares and par value of common stock of the corporation outstanding as of the beginning and end of the period; 
4. 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; 
5. 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; 
6. 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 thereto or supplements thereto, for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of the assets thereof shall be filed with respect to each foreign corporation.

(11) Such other information as may be required by the return form.

If a person is required to file a return under section 338 (a) and this article with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(d) Verification of returns.—All returns required by section 338 (a) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51–4.

(e) Penalties.—For criminal penalties for failure to file the returns required by section 338 (a) and this article, see section 340.

Art. 339–2. Time and place of filing returns.—Returns required by section 338 (b) and this article shall be filed under oath or affirmation in the same manner as prescribed in article 51–4.

(f) Return jointly made.—If two or more officers or directors of a foreign corporation are required to file annual information returns under section 338 (b) and this article for any taxable year of the corporation, any two or more of such officers or directors may in lieu of filing separate annual returns for such taxable year, jointly execute and file one annual return.

(b) Form of return.—The return under section 338 (b) and this article shall be made on Form 955, copies of which, upon request, may be procured from any collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(c) Contents of return.—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the following information:

(1) The gross income, deductions and credits, net income, Supplement P net income, and undistributed Supplement P net income of the foreign personal holding company for such taxable year, in complete detail;

(2) The same information with respect to such taxable year which is required by section 338 (a) and paragraph (d) of article 339–1, except that if all the required returns shall be made to such year have been filed under section 338 (a) and article 338–1, no information under section 338 (b) (2) and this paragraph need be set forth in such annual return; and

(3) Such other information as may be required by the return form.

(d) Verification of returns.—All returns required by section 338 (b) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51–4.

(e) Penalties.—For criminal penalties for failure to file the returns required by section 338 (b) and this article, see section 340.

Art. 339–3. Time and place of filing returns.—Returns required by section 338 (b) and this article shall be filed with the Commissioner of Internal Revenue, Washington, D. C., at the Internal Revenue Service 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.

Art. 339. Information returns by shareholders of certain foreign corporations.—(a) Requirement for filing returns.—On the sixtieth day after the date of the enactment of this Act each United States shareholder, or for whom 50 per cent or more in value of the outstanding stock of a foreign corporation is owned directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), if such foreign corporation with respect to its taxable year (if not beginning before August 26, 1939) 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 an information return as provided in section 339 (a) and this article.

(2) Returns for a period ending one month.—In the case of a foreign personal holding company which before the close of its taxable year specified in paragraph (a) (1) of this article, distributed to its shareholders 90 percent or more of its Supplement P net income, or which has no such net income for such taxable year, the period of the month, or portion thereof, in respect to which information returns under section 339 (a) shall be filed shall be the same as the periods prescribed in paragraph (a) (2) of article 338–1.

(3) Duplicate returns.—If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 339 (a) and article 338–1, such returns shall be considered as returns filed under section 339 (a).

(b) Form of return.—The return under section 339 (a) and this article shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(c) Contents of return.—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the 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 with respect to such taxable year as is required in subsection (a); except that if all the required returns with respect to such taxable year have been filed under section 338 (a) and article 338–1, no return shall be required under this subsection.

Art. 339–1. Information returns by shareholders of certain foreign corporations.—(a) Requirement for filing returns.—On the sixtieth day after the close of such taxable year which is referred to in subsection (a) of each month which begins after May 28, 1938, each United States shareholder, or for whom 50 per cent or more in value of the outstanding stock of a foreign corporation is owned directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), if such foreign corporation with respect to its taxable year (if not beginning before August 26, 1939) 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 an information return as provided in section 339 (a) and this article.

(2) Returns for a period ending one month.—In the case of a foreign personal holding company which before the close of its taxable year specified in subsection (a) of this article, distributed to its shareholders 90 percent or more of its Supplement P net income, or which has no such net income for such taxable year, the period of the month, or portion thereof, in respect to which information returns under section 339 (a) shall be filed shall be the same as the periods prescribed in subsection (a) (2) of article 338–1.

(3) Duplicate returns.—If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 339 (a) and article 338–1, such returns shall be considered as returns filed under section 339 (a).

(b) Form of return.—The return under section 339 (a) and this article shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(c) Contents of return.—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the preceding period the same information as required to be shown on that form by section 338 (a) and paragraph (c) of article 338–1.

If a person is required to file a return under section 339 (a) and this article with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(d) Verification of returns.—All returns required by section 339 (a) and this
article shall be verified under oath or affirmation in the same manner as prescribed in article 51-4.

(e) Penalties.—For criminal penalties for failure to file the returns required by section 339 (a) and this article, see section 340.

Art. 339-2. Annual information returns by shareholders of certain foreign corporations.—(a) Requirement for filing returns.—(1) General.—Under section 339 (b), on or before the fifteenth day of June following the close of the taxable year of a foreign personal holding company, each United States shareholder, by or for whom on such day sixty percent or more in value of the outstanding stock of the company is owned, directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), shall file with the Commissioner an information return as provided in that section and this article.

(2) Duplicate returns.—If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 338 (b) and article 338-2, such returns shall be considered as returns filed under section 339 (b).

(b) Form of return.—The return under section 339 (b) and this article shall be made on Form 597, copies of which, upon request, may be procured from any collector. Each shareholder shall carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Act.

(c) Contents of return.—The return shall, in accordance with the provisions of this article and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the same information which is required under section 339 (a), paragraph (e) of article 338-1 and paragraph (e) of article 339-1, except that if all the returns with respect to such year have been filed under section 339 (a) and article 339-1, no return under section 339 (b) and this article is required.

If a person is required to file an annual return under section 339 (b) and this article with respect to more than one foreign personal holding company, a separate return must be filed with respect to each foreign personal holding company.

(d) Verification of returns.—All returns required by section 339 (b) and this article shall be verified under oath or affirmation in the same manner as prescribed in article 51-4.

(e) Penalties.—For criminal penalties for failure to file the returns required by section 339 (b) and this article see section 340.

Art. 339-3. Time and place of filing returns.—Returns required by section 339 and the regulations thereunder shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times therein prescribed with such returns or with such returns and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after the time or times prescribed.

Art. 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 $5,000, or imprisoned for not more than one year, or both.

CHAPTER XXIV

Mutual Investment Companies

Supplement Q—Mutual Investment Companies

Art. 361. Definition of a mutual investment company.—In general.—For the purposes of this title the term "mutual investment company" means any domestic corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in Title I, if—

(1) It is organized for the purpose of, and substantially all of its business consists of, holding, investing, or reinvesting in, stock or securities.

(2) Its shareholders are offered the privilege of contributing shareholders are offered the privilege of participating in the profits of the corporation, and if substantially all of its business must be considered a mutual investment company as defined in Title I, if—

(a) Its business consists of holding, investing or reinvesting in, stock or securities. It is not sufficient that the corporation is engaged in holding, investing or reinvesting in, stock or securities. It must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered the privilege of participating in the profits of the corporation.

(3) It has any outstanding bonds or other obligations of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to obligations of the United States or in obligations of any one corporation chartered under a trust instrument or otherwise, as an investment trust, and whether of the fixed or general management type (other than a personal holding company as defined in section 402), which complies with all the conditions prescribed by section 361. As to definition of a corporation see section 391.

Art. 361-2. Proof of status of a mutual investment company.—(a) The Act requires that the corporation must have been organized for the purpose of, and that substantially all of its business must have consisted of, holding, investing or reinvesting in, stock or securities. It is not sufficient that the corporation is engaged in holding, investing or reinvesting in, stock or securities. It must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered the privilege of participating in the profits of the corporation. If such corporation is an instrumentality of the United States, or an instrumentality of the United States, it must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered the privilege of participating in the profits of the corporation.

(b) The Act provides that at least 95 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from sales or other disposition of stock or securities, and that less than 30 percent of the corporation's gross income for the taxable year must have been derived from the sale or other disposition of stock or securities held for less than six months.

(c) The Act provides that at least 95 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from sales or other disposition of stock or securities, and that less than 30 percent of the corporation's gross income for the taxable year must have been derived from the sale or other disposition of stock or securities held for less than six months.

(d) To determine whether the corporation is not a personal holding company as defined in Title I, it must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered the privilege of participating in the profits of the corporation. If such corporation is an instrumentality of the United States, or an instrumentality of the United States, it shall not be considered a mutual investment company.

(e) The Act provides that an amount not less than 95 percent of the corporation's net income for the taxable year must have been distributed to its shareholders, and that less than 30 percent of the corporation's net income for the taxable year must have been held by the corporation or other disposition of stock or securities does not enter into the computation. The determination of the period for which stock or securities have been held shall be governed by the provisions of section 117 (b) in so far as applicable.

(f) The Act provides that an amount not less than 95 percent of the corporation's net income for the taxable year must have been distributed to its shareholders, and that less than 30 percent of the corporation's net income for the taxable year must have been held by the corporation or other disposition of stock or securities does not enter into the computation. The determination of the period for which stock or securities have been held shall be governed by the provisions of section 117 (b) in so far as applicable.
holder upon redemption. A taxable divi-
dend is not distributed to its shareholders
during the taxable year within the meaning of sec. 361 (a) (4), unless the
dividend is received by the share-
dholders during the taxable year of the
company. See article 27 (b)–3, relating to
when dividends are considered paid.

(d) The Act requires that shareholder-
s must, upon reasonable notice, be en-
titled at all times during the taxable year
to redemption or purchase of their stock
for their proportionate interests in the
company's properties, or the cash

Art. 361-3. Records to be kept for
purpose of ascertaining actual ownership
of outstanding stock of mutual invest-
ment companies.—Every mutual invest-
ment company shall maintain at its

Art. 361-4. Records to be kept for
purpose of determining whether a cor-
poration claiming to be a mutual invest-
ment company is a personal holding com-
pany.—For the purpose of determin-

section 404 (a) (2)); the names and
addresses of his partners, if any, in any
partnership; and the maximum number
of shares of any corporation claiming to
be a mutual investment company, at any
time during the last half of the taxable year
of such company;

(5) the names and addresses of any
partnership, association, or trust in which he had a beneficial in-
terest to the extent of at least 10 percent
at any time during the period for which
such return is made, and the number of
shares of any corporation claiming to be
a mutual investment company actually
owned by such partnership, association,
or trust;

(6) the maximum number of shares
(including the number and face value of

Art. 361-5. Additional information re-
quired in returns of shareholders.—Any
person who fails to comply with the demand of a mutual invest-
ment company for the written state-
ments which articles 361-3 and 361-4
require the company to demand from
its shareholders shall submit as a part of
the income tax return required by the
Act of such person a statement showing,
to the best of his knowledge and belief—

(1) the number of shares actually
owned by him at any and all times

Sec. 352. Tax on mutual investment
companies.—(a) Supplement Q net income.—For
the purposes of this title the term "Supple-
ment Q net income" means the adjusted net
income minus the basic surtax credit
computed under section 27 (b) without the
application of paragraphs (2) and (3).
(b) Imposition of tax.—There shall be
levied, collected, and paid for each taxable
year upon the Supplement Q net income of
every mutual investment company a tax
equal to 16⅔ per cent of the amount

Art. 362-1. Tax on mutual investment
companies.—If a corporation, as defined
in

(redemption within 60 days of written notice is
redemption upon reasonable notice, even
though subject to exception in case of
extraordinary crises.

Art. 361-3. Records to be kept for
purpose of ascertaining actual ownership
of outstanding stock of mutual invest-
ment companies.—Every mutual invest-
ment company shall maintain at its

Art. 361-4. Records to be kept for
purpose of determining whether a cor-
poration claiming to be a mutual invest-
ment company is a personal holding com-
pany.—For the purpose of determin-

when dividends are considered paid.

Art. 361-4. Records to be kept for
purpose of determining whether a cor-
poration claiming to be a mutual invest-
ment company is a personal holding com-
pany.—For the purpose of determining
whether a domestic corporation claiming
to be a mutual investment company
is a personal holding company as
defined in section 403, the permanent
records of the corporation shall show, to
the best of the knowledge and belief of
the actual owners of its stock, the
maximum number of shares of the corpo-
rations (including the number and face
value of securities convertible into stock
of the corporation) to be considered
as actually or constructively owned by each
of the actual owners of any of its stock
at any time during the last half of the
corporation's taxable year, as provided in
section 404. Statements giving such
additional information shall be de-
manded not later than 30 days after the
close of the corporation's taxable
year, as follows:

(1) In the case of a corporation hav-
ing 2,000 or more actual owners of its
stock on any dividend payment date, as
disclosed by statements received in re-

Art. 361-4. Records to be kept for
purpose of determining whether a cor-
poration claiming to be a mutual invest-
ment company is a personal holding com-
pany.—For the purpose of determin-

when dividends are considered paid.
in section 901, shows to the satisfaction of the Commissioner that it is entitled to the status of a mutual investment
company, as defined in section 361, it is taxable upon the distribution of its income, as defined in section 362, at the rate of 16 1/2 percent. A mutual
investment company is not allowed, under section 362, the credit for dividends received provided in section 26 (b). In all other respects, a mutual
investment company is treated, for purposes of taxation, as any other corporation subject to taxation under the Act.

CHAPTER XXXVI
Exchanges and Distributions in Obedience
To Orders of Securities and Exchange Commission

Supplement R—Exchanges and Distributions
in Obedience to Orders of Securities and Exchange Commission

Sec. 371. Nonrecognition of gain or loss—
Exchanges of stock or securities only.—(a) No gain or loss shall be recognized to a transferor if stock or securities in a corpora-
tion which is a registered holding company or a majority-owned subsidiary company are exchanged for stock or
securities in another corporation which is a registered holding company or a majority-owned subsidiary company solely in exchange for stock or
securities (other than stock or securities which are nonexempt property), and the exchange is made by the transferor corporation in obedience to an order of the Securities and Exchange Commission.

(b) Exchanges of property by
corporations. No gain or loss shall be recog-
nized by the 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 simplifica-
tion 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 of a registered holding company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by the shareholder of stock or
securities in such corporation, no gain to the distributees 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 ex-
change for other property, and the exchange by such 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 surren-
der by such shareholder of stock or securities in the corporation making the distri-
bution, a corporation is made in obedience to an order of the
Securities and Exchange Commission.

(2) If the property received upon an ex-
change which is within any of the provisions of paragraph (1) of this section consists in whole or in part of stock or securities issued by the corporation from which such exchange proceeded, to the extent of an order of the Securities and Exchange Commission such stock or securities (other than stock which is received in exchange for both dividends and assets) are sold and the pro-
ceeds derived therefrom are in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporate-
tion outstanding on the date of such exchange, no gain or loss shall be recognized to the recipient corporation upon the sale of the stock or securities which such order was made; except that if any part of the proceeds derived from the sale of such stock or securities shall be re-
cipied, 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 amount not more than the amount that the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(e) Exchanges not solely
in
hind. —(1) If an exchange (other than the pro-
visions of this section) would be within the provisions of subsection (a) or (b) if it were not for the fact that the stock or
securities received in the exchange which is not so within paragraph (a) or (b), the
transferor corporation is a member of the same system group, or the proceeds derived from the sale of stock or securities to the extent of an order of the Securities and Exchange
Commission such stock or securities (other than stock which is received in exchange for both dividends and assets) are sold and the proceeds derived therefrom are in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporation outstanding on the date of such exchange, no gain or loss shall be recognized to the recipient corporation upon the sale of the stock or securities which such order was made; except that if any part of the proceeds derived from the sale of such stock or securities shall be re-
cipied, 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 amount not more than the amount that the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(2) If an exchange is within the provisions of paragraph (1) of this subsection (c), the Commissioner is within any of the provisions of section 112 (other than the provi-
sions of paragraph (b)), the Commissioner finds that it is necessary or appro-
priate to effectuate the provisions of section 112 (b) of the Public Utility Holding Company Act of 1935. Section 112 (c) provides that a distribution in liquidation of a corporation shall be treated as an exchange, and such a distribution is to be treated under the provisions of Supplement R. The order of the Sec-
urities and Exchange Commission must be one requiring or approving action of the type set forth in such order shall be given the respective def-
initions prescribed in section 371 (e).

The provisions of this section shall not apply to an exchange or distribution unless (1) the order of the Securities and Exchange Commission in obedience to which such exchange or distribution was made recites that such ex-
change or distribution is necessary or appro-
priate to effectuate the provisions of section 112 (b) of the Public Utility Holding Company Act of 1935. The Commissioner finds that it is neces-
sary or appropriate to effectuate a simplifica-
tion or geographical integration of a particular public utility holding-
company system. For specific require-
ments with respect to an order of the
Securities and Exchange Commission, see section 371 (f).

The requirements for nonrecognition of gain or loss as provided in section 371 are precisely stated with respect to the following four general types of transactions:

(1) The exchange that is provided for in section 371 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company;

(2) The exchange that is provided for in section 371 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property;

(3) The distribution that is provided for in section 371 (c), in which stock or securities are distributed to a share holder in a corporation which is a registered holding company or a majority-owned subsidiary company;

(4) The transfer that is provided for in section 371 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 371 (a) or (b) are prescribed in section 371 (e).
These new exceptions to the general rule are to be strictly construed as in the case of the other exceptions in section 112. Unless both the purpose and the specific requirements of Supplement R are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution of stock or securities is required 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, the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 371.

The application of the provisions of Supplement R is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not prohibited by such provisions, and the continuation of the basis as provided in section 372 is designed to effect this result. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of Supplement R shall not be construed or applied in such a way as to defeat this purpose.

Ann. 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 within the provisions of section 371 (a), unless the stock or securities transferred and those received are stock or securities as defined in 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 which 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 (d).

Ann. 371-3. Exchanges of property for property by corporations.—The nonrecognition of gain or loss provided for in section 371 (b) is limited to an exchange by a transferee corporation which is (1) a registered holding company or (2) 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). No consideration is to be given to any exchange between a registered holding company and any other nonexempt property. Nonrecognition of gain or loss provided for in section 371 (d) is designed to prevent the recognition either of gain or loss that may be transferred by the transferee corporation, in order that all of the transferor corporation’s gain on the exchange be nonrecognized. It is intended that the provisions of section 373 (f). This exchange, if it is within the provisions of section 371 (d), does not accomplish the purpose of the Exchange Act. This provision is to be strictly construed as in section 371 (a).

Example: The A Corporation, a registered holding company, is a member of a holding-company system No. 1 which comprises an integrated utility system in region X, except for the fact that the A Corporation owns all of the voting stock of the B Corporation with transmission lines in region Y. The transmission lines of the B Corporation have an adjusted basis of $300,000 and a fair market value of $325,000. The C Corporation, a registered holding company, is a member of a holding-company system No. 2 which comprises an integrated utility system in region Y, except for the fact that the C Corporation owns all of the voting stock of the D Corporation, an operating company with a generating plant and transmission lines in region X. The generating plant and transmission lines of the D Corporation have an adjusted basis of $275,000 and a fair market value of $285,000. In order for any exchange to come within this section, the parties to the exchange must be corporations which are members of the same system group.

As stated in article 371-1, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for...
in Supplement R, even though such transaction occurs simultaneously or in connection with the exchange or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized on the discharge, or the removal of the burden, of the peculiar 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, specifically described in said 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 are 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 bought or sold for something other than its own securities (see article 372-4) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized. No exchange or distribution may be made without the recognition of gain or loss as provided for in section 371 (d) (1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 371 (d) (1) and also may be considered to be within some other provisions of section 371, it shall be considered that only the provisions of section 371 (d) (1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

Ann. 371-6. Sale of stock or securities received by members of a system group.—Section 371 (d) (2) provides that to the extent that property received upon an exchange by corpora-
tion, section 371 (f) provides that the provisions of section 371 shall not apply to an exchange or distribution unless each of the following requirements is met:

(1) The order of the Securities and Exchange Commission must recite that the exchange or distribution is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935.

(2) The order shall specify and itemize the stock and securities and other property (including money) which are ordered to be transferred and received upon the exchange or distribution, so as clearly to identify such property.

(3) The exchange or distribution shall be made in obedience to the order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 371, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is of the essence, and must be met if gain or loss is not to be recognized upon the transaction.

Ann. 371-8. Nonapplication of other provisions of the Act.—The effect of section 371 (g) is that an exchange, sale, or distribution which is within section 371 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by Supplement R, the purpose being to prevent overlapping of the provisions of such supplement and other provisions of the Act. In other words, if by virtue of section 371 any portion of a person's gain or loss on any particular exchange, sale or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 371, regardless of what the rest of the provisions of 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 112 if Supplement R had not been enacted. On the other hand, if section 371 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of the Act as if Supplement R had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by other provisions of the Act as if Supplement R had not been enacted.

Ann. 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 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 the fair market value thereof at the date of the exchange, together with a statement of the cost or other basis of such stock or securities.

(b) Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission shall file a copy of the order of the Securities and Exchange Commission directed to such corporation with its income tax return for the taxable year in which such exchange takes place.

(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 the fair market value thereof at the date of such distribution, together with a statement of the cost or other basis of such stock or securities.

(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 or loss upon such distribution, including:

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) If any other corporation transfers any nonexempt property, the amount of the fair market value of the property in question, and the fair market value thereof at the time of the exchange.

(f) Every corporation from which stock or securities were 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.

(c) 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 and undisguising 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 purchase price or 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 property.

Sec. 371. Basis for determining gain or loss.—(a) Exchanges generally.—If the property was acquired upon an exchange to which section 371 (a) (b), (c) (d), or (e) applies, the basis shall be the same as in the case of the property exchanged, decreased by the amount of money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer (as the case may be) 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 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 property (other than money) received, and for the purpose of the allocation there shall be assigned to such property the tax exempt property (as property not permitted to be received (including money) the amount equivalent to its fair market value at the date of the exchange. This subsection shall not apply unless the 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), (c), (d), or (e), the property was acquired by a corporation, held for a purpose other than sale or contribution to capital, or in consideration for stock or securities issued by the corporation receiving the property, the basis of the property transferred or the 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 or distribution to the corporation on the date of the exchange.

(c) Distributions of stock or securities.—If the stock or securities received in a distribution subject to the provisions of section 371 (c), 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 of Internal Revenue, between such such stock or securities distributed.

(d) Transfer to a system group.—If the property was acquired by a corporation which is a member of a system group upon a transfer or distribution, as described in section 371 (d), the basis of such stock or securities shall be either (A) the same as in the case of the property transferred theretoe, or (B) (the basis (adjusted to the date of the exchange) of the property transferred to such corporation, as the case may be, or to (A) the same as in the case of the property transferred thereto, or (B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower, or (C) as part consideration for the property transferred to such corporation, if the basis of such stock or securities shall be either (A) the same as in the case of the property transferred theretoe, or (B) (the basis (adjusted to the date of the exchange, as described in section 371 (b), if no part of the gain or loss upon such exchange was recognized under section 371 (b), 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 such 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 (b), 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 property transferred by the taxpayer.
an amount equivalent to its fair market value at the date of the exchange.

Section 371 (e) provides that no loss may be recognized in the case of an exchange of stock or securities for stock or securities as described in section 371 (a), or on an exchange of property for property as described in section 371 (b), although the taxpayer receives money or other non-exempt 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 non-exempt property (other than money) an amount of such basis equivalent to the fair market value of such non-exempt property at the date of the exchange.

Section 372 (a) does not apply in determining property acquired by a corporation by the issuance of its stock or securities as part or sole consideration for the property transferred. For the rule in such cases, see section 372 (b).

Art. 372-2. Basis of property acquired by corporation under section 371 (a), 371 (b), or 371 (e) as contribution of capital or surplus, or in consideration for its own stock or securities.—If, in connection with an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), or an exchange as described in section 371 (e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 372 (b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property acquired shall be determined in accordance with the following rules:

1. If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

2. If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class.

Within the meaning of the foregoing provisions stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class. As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see section 372 (d).

Art. 372-4. Basis of property acquired under certain 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), the following rules shall apply:

1. 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), the basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

2. 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), the following rules shall apply:

a. The basis of such property in the hands of the transferring corporation shall be the basis of such property in the hands of the transferring corporation.

b. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

c. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

3. 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), the following rules shall apply:

a. The basis of such property in the hands of the transferring corporation shall be the basis of such property in the hands of the transferring corporation.

b. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

c. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

4. 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), the following rules shall apply:

a. The basis of such property in the hands of the transferring corporation shall be the basis of such property in the hands of the transferring corporation.

b. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

c. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

5. 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), the following rules shall apply:

a. The basis of such property in the hands of the transferring corporation shall be the basis of such property in the hands of the transferring corporation.

b. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

c. The basis of such property in the hands of the acquiring corporation shall be the basis of such property in the hands of the transferring corporation.

Except as otherwise indicated in this article, this rule will apply equally to the cases in which the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in article 371-5.

An exception to this general rule is provided for in case the property acquired consists of stock or securities issued by the corporation in 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 exchanges 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 $600,000, and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $800,000. 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 Corporat-
tion 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 the receipt of the order by the B Corporation, and not the amount established as $500,000/1,000,000ths of $1,100,000, or $550,000.

Sec. 372. Definitions.—As used in this supplement—

(a) the term "order of the Securities and Exchange Commission" means an order (1) issued after May 23, 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) of the Public Utility Holding Company Act of 1935, or (2) issued by the Commission subsequent to December 31, 1939, in which it is expressly stated that an order of the character specified in clause (1) is amended or supplemented, and (2) which has become final in accordance with law.

(b) The terms "registered holding company," "holding-company system," and "associate company" shall have the meanings assigned to by sections 6 of the Public Utility Holding Company Act of 1935.

(c) The term "majority-owned subsidiary company" or "subsidiary 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 on payment of dividends or other special circumstances) is owned wholly by such registered holding company, or partly by one or more majority-owned subsidiary companies thereof, or partly by one or more companies which has become an instrumentality of a public-utility company, or partly by one or more companies which are connected with a public-utility company by notes, drafts, bills of exchange, and bankers' acceptances (including bank credit for the purpose of enabling such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to carry on its business or to continue to control one or more integrated public-utility systems). And to such extent as it seems necessary, or economically necessary or appropriate to do so, any order of the Commission shall find necessary in order that such holding company or any subsidiary company thereof shall be subject to Judicial review as provided in paragraph (2) of section 8 of the Public Utility Holding Company Act of 1935.

Section 11 (e) of the Public Utility Holding Company Act of 1935 provides:

(b) The term "nonequity property" means—

(1) Any consideration in the form of a cancellation or assumption of debts or other liabilities (including a continuance of or assumption of covenants 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 not exceeding twenty-four months, exclusive of days of grace;

(3) Securities issued or guaranteed as to principal or interest by government or government subdivision thereof (including those issued by a corporation which is an instrumentality of a government or government subdivision thereof) which are registered in the name of the United States, or are deposited with, or are held by, a pledgee of the United States as pledgee of securities in the name of the United States or as trustee for the United States;

(4) Stock or securities which were acquired after February 28, 1938, unless such stock or securities (other than obligations described as nonequity property in paragraph (2) or (3)) were acquired in accordance with an order of the Securities and Exchange Commission;

(5) Money and the right to receive money not evidenced by a security other than an obligation described as nonequity property in paragraph (2) or (3).

(f) The terms "stock or securities" mean shares of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness which are receivable only on demand or on death, or are receivable only on the happening of an event certain in interest or right to subscribe to or purchase any of the foregoing.

Arrt. 373.1, Definitions.—(a) "Order of the Securities and Exchange Commission."—An order of the Securities and Exchange Commission as defined in section 11 (b) of the Public Utility Holding Company Act of 1935 shall be issued after May 23, 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) of the Public Utility Holding Company Act of 1935 to effectuate the provisions of section 11 (b) of such Act (or must amend or supplement an order so issued and expressly state that it amends or supplements such an order). In all cases the order must have become final in accordance with law; i.e., it must be valid, outstanding, and not subject to further appeal. See further sections 373 (a) and 371 (f). Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938,

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company, or any associate company to such holding company, which has become an instrumentality of a public-utility company, shall have the Securities and Exchange Commission as sole trustee, to hold or administer any nonequity property or nonequity property which the Court of Appeals directs to be held or administered by the Commission, at the request of the company, may by order require any change in the corporate structure or existence of any company which is 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 which has become final in accordance with law, unless such order has been made subject to further appeal.

No. V. 214, 1939
Exchange Commission of such notification of registration. The term “registered holding company” as used in these regulations means any 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 to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company as 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 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.

(a) “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 B 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 50 percent of each class of such stock 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 type of stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 373 (c), yet as a general rule both types of ownership tests must be met under section 373 (d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) “Nonexempt property.”—The term “nonexempt property” is defined by section 373 (e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example,

(A) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(B) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(C) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers’ acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 375 (a)) and are not nonexempt property within the meaning of section 373 (e) (2) or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 373 (e) (2) or (3).

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).

(6) 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.
FEDERAL REGISTER, Tuesday, February 14, 1939

823

tributed Title IA net income of every personal holding company (as defined in the tax imposed by Title I) a surtax equal to the sum of the following:

(1) 65 percent of the amount thereof not in excess of $2,000; plus
(2) 75 percent of the amount thereof in excess of $2,000.

Art. 401--Surtax on personal holding companies.---Section 401 imposes for each taxable year beginning after December 31, 1937 (in addition to the taxes imposed by Title I), a graduated income tax or surtax upon corporations classified as personal holding companies and, under the circumstances specified in section 402 (c), upon an affiliated group of railroad corporations. Corporations so classified are exempt from the surtax on corporations improperly accumulating surplus imposed by section 402, but are not exempt from the other taxes imposed by Title I. Unlike the surtax imposed by section 402, the surtax imposed by section 401 applies to all personal holding companies defined as such in section 402 and article 402--1, regardless of whether or not they were formed or availed of the earnings and profits for the purpose of avoiding surtax upon shareholders. The surtax imposed by section 401 is 65 percent of the amount of the undistributed Title IA net income not in excess of $2,000, and 75 percent of the amount of the undistributed Title IA net income in excess of $2,000.

A foreign corporation, whether resident or nonresident, which is classified as a personal holding company under section 402 (not including a foreign personal holding company as defined in section 331) is subject to the tax imposed by section 401 with respect to its income from sources within the United States even though such income is not fixed or determinable annual or periodical income specified in section 331 (a).

(See section 331 (b) defining "personal holding company" as used in Title IA does not include a foreign corporation if (1) its gross income from sources within the United States for the period specified in section 119 (a) (2) (B) is less than 50 percent of its total gross income from sources within the United States, 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.

Art. 402--Definition of personal holding company.---The term "personal holding company" means any 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 sources within the United States, 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.

Art. 402--General rules.---For the purposes of this title, and Title I, the term "personal holding company" means any corporation if

(1) Gross income requirement.---At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 403; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be increased by amounts not less than 50 percent, until a taxable year during the whole of the last half of which the stock ownership requirement is met, exists, or until the expiration of three consecutive taxable years in each of which less than 75 percent of the gross income of the corporation for the taxable year is personal holding company income.

(2) Stock ownership requirement.---At any time during the last half of the taxable year for which its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

(b) Exceptions.---The term "personal holding company" does not include a corporation (a) owning, controlling, or who is under the common control with, a domestic life insurance company, or (b) which is an "investment company" as defined in section 403; but "personal holding company" means any foreign corporation.

If less than 50 percent of the amount of the gross income of the corporation for the taxable year exceeding $300 in principal amount, if such interest is not payable in advance or compounded and is computed only on unpaid balances.

(c) Corporations making consolidated returns.---If the common parent corporation of an affiliated group of corporations making a consolidated return under the provisions of section 111, satisfies the gross income requirement provided in section 402 (a) (2), and the income of such affiliated group, deemed or included as provided in section 401, is not less than 50 percent of the gross income requirement provided in section 402 (a) (1), such affiliated group shall be subject to the surtax imposed by this title.

Art. 402--Gross income requirement.---To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year be personal holding company income as defined in section 403:

(a) 80 percent or more; or
(b) 70 percent or more if the corporation has been classified as a personal holding company for any taxable year beginning after December 31, 1936, unless:

(1) A taxable year has intervened since the last taxable year for which it was so classified, during no part of the last half of which the stock ownership requirement specified in section 402 (a) (2) existed; or
(2) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its personal holding company income was less than 70 percent of its gross income.

In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and the regulations prescribed under that section.

Ann. 402--1. 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 held, directly or indirectly, by not more than five individuals. For such purpose, the ownership of the stock must be determined as provided in section 404 and articles 404 (a) 1 to 404 (a) 7 and article 404 (b) 1.

In the event of any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration.

In determining whether the statutory conditions with respect to stock ownership are present at any time during the last half of the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed to refer to 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 paragraphs are applicable in determining the stock ownership requirement specified in section 403 (e), relating to personal service contracts and in section 403 (d), relating to the use of corporation property by a shareholder. The stock ownership requirement specified in these sections relates, however, to the stock outstanding at any time during the entire taxable year and not merely during the last half thereof.

Sec. 403. Personal holding company income.---For the purposes of this title the term "personal holding company income" means the portion of the gross income which consists of:

(a) Dividends, interest (other than interest of a pecuniary nature, including interest on personal service contracts (p), royalties (other than mineral, oil, or gas royalties), and annuities.

(c) Commodity transactions.---Gains from future transactions in any commodity on or for a commodity exchange. This subsection shall not apply to gains by a producer, processor, retailer, merchant, or handler of the commodity which arises out of bona fide hedging transactions reasonably necessary to conduct the purposes of such business.
(3) Royalties (other than mineral, oil, or gas royalties).—The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other personal property rights; includes amounts received from the sale of oil, gas, or other mineral royalties, 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 developed the natural resource in respect of which such overriding royalties are paid.

(4) Annuities.—The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).

(5) Gains from the sale or exchange of stock or securities.—The term "gains from the sale or exchange of stock or securities" as used in section 403 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Act) of a corporation; certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral royalty, or lease, collateral 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 "gains from the sale or exchange of stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealer in stock or securities" means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(6) Gains from futures transactions in commodities.—Gains from futures transactions in commodities include gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, but do not include gains from cash transactions. For purposes of this subsection the term "commodity" includes both fundamental or non-fundamental, producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. In general, personal holding company income includes gains on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

(7) Income from estates and trusts.—The income from estates and trusts which is to be included in personal holding company income as amounts received under personal service contracts consist of amounts received by a producer, processor, merchant, or handler of the commodity, which arises 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.
in engineering. The N Corporation entered into a contract with the O Corporation to lease and develop the natural resources owned by the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute personal holding company income.

(9) Compensation for use of property.—The compensation for the use of, or the right to use, property of the corporation which is to be included in personal holding company income consists of amounts received as compensation (however designated and from whomsoever received) for the use of, or the right to use, the property, whether such right is obtained directly from the corporation or by means of a sublessee or other arrangement. The property may consist of a yacht, a city residence, a country house, or any other kind of property. See section 404 and articles 404(a)–1 to 404(a)–7, article 404(b)–1 and the last paragraph of article 403–3.

(10) Rents (including interest constituting rent).—The rents which are to be included in personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation, but do not include amounts constituting personal holding company income under section 403(d) and paragraph (9) of this article. However, rents do not constitute personal holding company income if constituting 50 percent or more of the gross income of the corporation.

(11) Mineral, oil, or gas royalties.—The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (A) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (B) the aggregate amount of deductions allowable for expenses under section 23(a) (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

The term "mineral, oil, or gas royalties" means all royalties, except over-producing royalties, received from any interest in mineral, oil, or gas properties.

The term "mineral" includes the ores the term "oil" includes all petroleum and the term "gas" includes all natural gas. The term "gas" includes all natural gas and includes any gas the use of which is determined by the application of paragraph (e). The term "over-producing royalties" means amounts received from the sublessee by operating the property which originally leased and developed the natural resource property in respect of which such over-producing royalties are paid.

Sec. 404. Stock ownership.—(a) Constructive ownership.—For the purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 403, or on section 403(f),—

(1) Stock not owned by individual.—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or the individual, or such right is obtained directly from the corporation or by means of a sublessee or other arrangement. An individual shall be considered as owning the stock owned, directly or indirectly, by or for him or by his family or by his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) Option.—If any person has an option to acquire stock which shall be considered as owned by him for the purposes of this paragraph the option shall be exercised by him for the purposes of the stock ownership—

(a) By purchase of the stock for the stock owned, directly or indirectly, by or for him or by his family or by his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) Application of family and partnership rule.—For the purposes of the stock ownership the family and partnership rule shall be applied in determining whether a stock owner is an individual under either paragraph (2) or paragraph (3). 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.

(4) Application of family-partnership and option rules.—Paragraphs (2) and (3) shall be applied:—

(a) For the purposes of the stock ownership sentence provided in section 403(c), but only if, the effect is to make the stock owner a family member of the corporation, partnership, or trust, or is to include the beneficial interest therein. See also article 403 (a)–6.

(b) For the purposes of the stock ownership sentence provided in section 403(c), but only if, the effect is to make the stock owner a family member of the corporation, partnership, or trust, or is to include the beneficial interest therein. See also article 403 (a)–6.

(c) Constructive ownership as actual ownership.—Stock constructedly owned by a person by reason of the application of paragraph (1) or (2), shall, for the purpose of applying paragraphs (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 (3) shall not be treated as owned by him for the purposes of the stock ownership—

(a) By the stock owner, directly or indirectly, by or for him or by his family or by his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(b) Option rule in family and partnership rule.—If stock may be considered as owned by the stock owner, directly or indirectly, by or for him or by his family or by his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(c) The stock ownership the family and partnership rule shall be applied in determining whether a stock owner is an individual under either paragraph (2) or paragraph (3). 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.

The application of the family and partnership rule in determining the ownership of stock for any of the purposes set forth in article 404 (a)–1, stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate, and if each 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 proportionately by A and B, and none of whom were partners, shareholders as follows:

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:
By applying the statutory rule provided in section 404 (a) (2) two individuals own more than 50 percent of the outstanding stock as follows:

<table>
<thead>
<tr>
<th>Relationships</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (including AP, AW, AB, AS, ASHS, AP)</td>
<td>160</td>
</tr>
<tr>
<td>B (including BP, BW, BB, BS, BSHS)</td>
<td>160</td>
</tr>
<tr>
<td>C (including CS, CW, CWBS)</td>
<td>220</td>
</tr>
<tr>
<td>D (including D, DFP, DBW)</td>
<td>200</td>
</tr>
</tbody>
</table>

Total, or more than 50 percent - 910

Individual A represents the obvious case where the head of the family owns the bulk of the stock and is the head of the group. Individual B represents the case where A 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 preponderance of holdings of others eliminate that individual from the group.

The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in (b) and (c) of article 404 (a) - L.

Arr. 404 (a) - Options. - In determining the ownership of stock for any of the purposes set forth in article 404 (a) - L, if any person has an option to acquire stock, such stock may be considered as owned by the optionee. The term "option" as used in this article includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

Arr. 404 (a) - S. Application of family-partnership and option rules. - The family and partnership rule provided in section 404 (a) (2) and article 404 (a) - S and the option rule provided in section 404 (a) (3) and article 404 (a) - 4 shall be applied -

(a) for the purpose stated in (a) of article 404 (a) - 1, if, but only if, the effect of such application is to make the corporation a personal holding company, or

(b) for the purpose stated in (b) of article 404 (a) - 1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such contract personal holding company income, or

(c) for the purpose stated in (e) of article 404 (a) - 4, if, but only if, the effect of such application is to make the compensation for the use of property personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in article 404 (a) - 1.

Arr. 404 (a) - 6. Constructive ownership is actual ownership. - In determining the ownership of stock for any of the purposes set forth in article 404 (a) - 1 -

(a) stock constructively owned by a person by reason of the application of the rule provided in section 404 (a) - 1, relating to stock not owned by an individual, is to be considered as actually owned by such person for the purpose of applying such rule.

(b) stock constructively owned by a person by reason of the application of the option rule provided in section 404 (a) - 3 is to be considered as actually owned by such person for the purpose of applying such rule.

(c) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 404 (a) (2) is to be considered as actually owned by such person for the purpose of applying such rule.

(d) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 404 (a) (2) is to be considered as actually owned by such person for the purpose of applying such rule.

(e) stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 404 (a) (2) is to be considered as actually owned by such person for the purpose of applying such rule.

The application of this article may be illustrated by the following examples:

Example 1. : A's wife, AW, owns all of the stock of the M Corporation, which in turn owns all the stock of the P Corporation. The P Corporation in turn owns all the stock of the P Corporation.

Under the rule provided in section 404 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the O Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the stock of the M Corporation is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 404 (a) (2) in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 404 (a) (2) in order to make A the constructive owner of the stock of the P Corporation. If such application is necessary for any of the purposes set forth in article 404 (a) - 1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example 2. : B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B.

Under the option rule provided in section 404 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 404 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 404 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 404 (a) (2) in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make 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.

Arr. 404 (a) - 7. Option rule in lieu of family and partnership rule. - If, in determining the constructive owner of the stock for any of the purposes set forth in article 404 (a) - 1 stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 404 (a) - S and the option rule provided in section 404 (a) - 4, the stock may be considered as actually owned by such person.
(2) For the purposes of the stock ownership requirement provided in section 402 (a) (3), see article 404 (a) (2) and the option rule provided in section 404 (a) (3) (see article 404 (a) (3)), such stock shall be considered as outstanding stock by the individual by reason of the application of the option rule.

The application of this article may be illustrated by the following example:

Example: Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in article 404 (a) (1), to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See article 404 (a) (6).)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under article 404 (a) (6), such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule in his case, and so make another member of A's family, for example B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 404 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own stock plus A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be considered shall not be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included; but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

Art. 404 (b)-1. Convertible securities.-Under section 404 (b), outstanding securities of a corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible into or out of stock at the option of the holder), shall be considered as outstanding stock of the corporation for the purpose of the stock ownership requirement provided in section 402 (a) (2), but only if the effect of such consideration is to make the corporation a personal holding company.

Convertible securities shall be considered as outstanding stock for the purpose of section 402 (a) (re), relating to compensation for the use of property, but in the event of such consideration it is made to the effect that the stock so considered is to be included 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 so considered as outstanding stock under such section (c) of this article for the purpose of the same rule with respect to the ownership of the stock, then only that portion of the stock which is not so considered as outstanding stock under such section shall be included in the computation of personal holding company income. The consideration of convertible securities as outstanding stock under section 402 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a personal holding company;
The term "Indebtedness" does not include the relationship of debtor and creditor concerning the form of an indebtedness, so long as the obligation of a corporation on its demand or within a given time, in absolute and not contingent, to pay, the term "indebtedness" means an obligation of any kind incurred prior to January 1, 1934. A 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 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.

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 (all amounts from whatever source) used and, as well, all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions were not permitted.

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 any taxable 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. 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.

Reasonableness of the amounts used or irrevocably set aside by reason of an amount set aside to pay or to retire an indebtedness, in whole or in part, at or prior to the maturity and retirement of the 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. 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.

Reasonableness of the amounts used or irrevocably set aside by reason of an amount set aside to pay or to retire an indebtedness, in whole or in part, at or prior to the maturity and retirement of the 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. 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.

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.

Additional deductions.—There shall be allowed as deductions—

(a) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23, but not including the tax imposed by section 102, section 401, or a section of a revenue-law or tax-law corresponding to either of such sections.

(b) In lieu of the deduction allowed by section 23 (q), contributions or gifts paid, or 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 the extent such liability of the decedent existed prior to January 1, 1934. No deduction shall be allowed under subsection (b) of this section.

(c) 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 to whom a distribution is made, and without the deduction of the amount disallowed under subsection (b) of this section.

(d) The foreign tax credit permitted by section 23 (q), contributions or gifts paid, or 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 the extent such liability of the decedent existed prior to January 1, 1934. No deduction shall be allowed under this section.

Deductions not allowed.—The aggregate of the deductions allowed under sections 23 (a), (b), (c), and 406 (a), under section 406 (b) the aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (i), relating to depreciation, which are allowable 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) 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.
Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing its Title IA net income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(a) A description of the property;
(b) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;
(c) The name and address of the person from whom acquired and the date thereof;
(d) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;
(e) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amounts of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;
(f) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefore;
(g) A copy of the contract, lease or rental agreement;
(h) The purpose for which the property was used;
(i) The business carried on by the corporation with respect to which the property was held and the gross income, expenses and net income derived from the conduct of such business for the taxable year and for each of the five preceding years;
(j) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and
(k) Any other information pertinent to the taxpayer's claim.

The following facts exist with respect to the O Corporation, a personal holding company which is on the cash receipts and disbursements basis, for the calendar year 1938:

The net income, as computed under Title IA, amounts to $130,000.

Federal income tax for the year 1937 and March 15, 1938, aggregates $17,500. This amount includes the tax on compensation received under section 14 of the Revenue Act of 1936 but does not include excess-profits tax imposed by section 106 of the Revenue Act of 1935, surtax imposed by section 102 of the Revenue Act of 1936, or section 351 of the latter Act as amended by the Revenue Act of 1937, or a section of a prior income-tax law corresponding to either of such sections 102 or 351.

Contributions or gifts payment of which is made to or for the use of donors therewith specified $15,000, of which $10,000 is deducted in arriving at the net income under Title IA.

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 stock in the corporation allocable to the maintenance and operation of the country estate amount to $30,000. The yearly depreciation on the depreciable property of the estate amounts to $5,000. The corporation has not established its right to claim the entire amount of the expenses and depreciation applicable to the estate as provided in section 406 (b) and article 406-1.

Dividends paid by the corporation to its shareholders during the taxable year which are allowable as a credit under section 27 (a) amount to $130,000. The amount used during the year to pay indebtedness incurred by the corporation prior to January 1, 1934, is $32,750.

On March 15, 1939, the corporation paid its shareholders a taxable dividend of $15,000 and in its return, on Form 1120H, claimed a deduction for that amount under section 406 (c). The accumulated earnings and profits as of the close of the taxable year 1938 were more than $15,000.

The Title IA net income, the undisbursed Title IA net income, and the surtax are computed as follows:

Net income under Title IA: $110,000
Contributions deductible in computing net income under section 27 (a): 7,500
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 credit for the amount disallowed under section 406 (b): $75,000

Amount used to pay indebtedness incurred by the corporation prior to January 1, 1934: $32,750
Amount payable when claim is made: $15,000

Dividends paid March 15, 1939 (subject to limitation in section 102 (c) (2)):

(1) by a decision of the Board of Tax Appeals which has become final: $15,000
(2) by a clear agreement made under section 106 of the Revenue Act of 1926, as amended: $15,000
(3) by a final judgment in a suit to which the United States is a party: $15,000

Total surtax: $1,750

Sec. 407. Deficiency dividends; Credits and refunds;—(a) Credit against unpaid deficiency owed—(a) Credit against unpaid deficiency owed

(A) If claim for refund is 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:

(1) 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 the deficiency, and if the deficiency is the excess of $2,000, plus 75 per centum of the amount of the excess of $2,000, but such credit or refund shall not exceed the portion of such asserted deficiency which is made to or for the use of donees as defined in section 407 of the Revenue Act of 1926, as amended; or
(2) by a clear agreement made under section 106 of the Revenue Act of 1926, as amended: $15,000
(3) by a decision of the Board of Tax Appeals which has become final: $15,000

Federal income taxes: $17,500
Contributions deductible under section 406 (a) (1) 15 per centum of $125,000: $18,750

Offense under Title IA net income: $173,750

Dividends paid credit: $125,000
Amount used to pay indebtedness: $32,750

Undistributed Title IA net income: $156,750

Amount taxable at 63 per cent (not in excess of $2,000): $4,500
Amount taxable at 75 per cent ($4,500 minus $2,000): $2,500
Surtax on $2,000 at 63 per cent: $1,323
Surtax on $2,500 at 75 per cent: $1,875

Total surtax: $3,750

Sec. 407. Deficiency dividends: Credits and refunds;—(a) Credit against unpaid deficiency owed—(c) Credit against unpaid deficiency owed

(1) by a decision of the Board of Tax Appeals which has become final: $15,000
(2) by a clear agreement made under section 106 of the Revenue Act of 1926, as amended: $15,000
(3) by a final judgment in a suit to which the United States is a party: $15,000

Total surtax: $3,750

FEDERAL REGISTER, Tuesday, February 14, 1939

No. 20 — 5

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Deficiency dividends.—(1) Definition.—For the purpose of this title, the term “deficiency dividends” means the amount of the claim for a deficiency dividends credit as provided in section 407 (a) (1), (2), or (3), the corporation, under certain circumstances, is entitled to a deficiency dividends credit which, though it may not exceed the amount of the deficiency, is to be applied against the amount of such deficiency dividend and all interest, additional amounts, and additions to the tax provided by law not paid on or before the date when the closing agreement is filed under section 407 (d). The amount of the deficiency dividends credit is 65 percent of the amount of “deficiency dividends” (as defined in section 407 (c)) not in excess of $2,000 plus 3 percent of the amount of such dividends in excess of $2,000, and the allowance of the credit is subject to the following conditions, qualifications and limitations:

(1) The corporation is required under section 407 (c), within 30 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, to file a notice of its intention to claim a deficiency dividends credit, which notice shall specify the amount of the credit intended to be claimed.

(2) The corporation is required under section 407 (d), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, to file a claim with respect to the credit for deficiency dividends;

(3) The deficiency dividends are required under section 407 (c) to be paid prior to the filing of the claim for a deficiency dividends credit and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under Title I for the year in which paid (see section 27 (d)), and must be nonpreferential (see section 27 (b)); and

(4) Under section 407 (a) the deficiency dividends credit shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which is not paid on or before the date of the closing agreement, or the date upon which the decision of the Board or the judgment becomes final, as the case may be.

Form of notification.—The notice of intention to have dividends considered as deficiency dividends for the purposes of the allowance of credit under section 407 (a) shall be filed by the Secretary, as provided in section 407 (b), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, as the case may be.

The amount of the deficiency dividends credit is 65 percent of the amount of “deficiency dividends” (as defined in section 407 (c)) not in excess of $2,000 plus 3 percent of the amount of such dividends in excess of $2,000, and the allowance of the credit is subject to the following conditions, qualifications and limitations:

(1) The corporation is required under section 407 (c), within 30 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, to file a notice of its intention to claim a deficiency dividends credit, which notice shall specify the amount of the credit intended to be claimed.

(2) The corporation is required under section 407 (d), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, to file a claim with respect to the credit for deficiency dividends;

(3) The deficiency dividends are required under section 407 (c) to be paid prior to the filing of the claim for a deficiency dividends credit and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under Title I for the year in which paid (see section 27 (d)), and must be nonpreferential (see section 27 (b)); and

(4) Under section 407 (a) the deficiency dividends credit shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which is not paid on or before the date of the closing agreement, or the date upon which the decision of the Board or the judgment becomes final, as the case may be.

Form of notification.—The notice of intention to have dividends considered as deficiency dividends for the purposes of the allowance of credit under section 407 (a) shall be filed by the Secretary, as provided in section 407 (b), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or the judgment becomes final, as the case may be.
407 (a) shall be made, under oath or affirmation, on Form 976, copies of which, upon request, may be procured from any collector.

(c) Contents of notification.—The notification shall, in accordance with the provisions of this article and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;
(2) The place and date of incorporation;
(3) The amount of the unpaid deficiency with respect to the tax imposed by Title I A, how it was established (closing agreement, Board decision or court judgment); the date thereof and the taxable year or years involved;
(4) The amount of the credit intended to be claimed as a deficiency dividends credit; and
(5) Such other information as may be required by the notification form.

(d) Time and place of filing notification.—The notification required by section 407 (a) (1) and this article shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 30 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(e) Claim for deficiency dividends credit.—For claims for deficiency dividends credits, see article 407-5.

Anx. 407-4. Credit or refund of deficiency dividends credit.—If the Commissioner has determined that there is a deficiency with respect to the tax imposed by Title I A for any taxable year beginning after December 31, 1937, and the corporation has paid any portion of such asserted deficiency, the corporation, under certain circumstances, may claim a credit or refund of such deficiency. The amount of the credit or refund is 65 percent of the amount of “deficiency dividends” (as defined in section 407 (c)) not in excess of $2,000, plus 75 percent of the amount of such dividends in excess of $2,000, and the allowance of the credit or refund is subject to the following conditions, qualifications and limitations:

(1) It must be established that the amount for which credit or refund is sought was the whole or a part of a deficiency at the time when paid, and such fact must be established as provided in section 407 (b) (1), (2) or (3);
(2) The corporation is required under section 407 (d), within 60 days after the date of the closing agreement or the date upon which the decision of the Board or judgment becomes final to file a claim for credit or refund;
(3) “Deficiency dividends” are required under section 407 (c), to be paid prior to the filing of the claim for credit or refund and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under Title I for the year in which paid (see section 27 (1)), and must be non-preferential (see section 27 (3));
(4) The credit or refund shall not exceed the portion of the deficiency (not counting the interest, additional dividends to the tax, provided by law) which was paid by the corporation;
(5) The credit or refund shall be made as provided in section 322, but without regard to section 322 (b) (relating to the limitations on the allowance of refunds or credits), or section 301 (c) (relating to the effect of petitions to the Board on refunds or credits);
(6) No credit or refund shall be made under section 407 (b) with respect to any amount of tax paid after the date of the closing agreement, or the date the decision of the Board or the judgment becomes final, as the case may be; and
(7) No interest shall be allowed on the credit or refund.

Anx. 407-5. Claim for deficiency dividends credit or credit or refund.—(a) General.—A claim for a deficiency dividends credit, or credit or refund of deficiency dividends, under section 407 (b), relating to credit against unpaid deficiency, and under section 407 (b), relating to credit or refund of deficiency paid, must be filed within 60 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

(b) Form of claim.—The claim for a deficiency dividends credit, or credit or refund, shall be made in duplicate, under oath or affirmation, on Form 796, 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. The claim shall, in accordance with the provisions of this article and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;
(2) The place and date of incorporation;
(3) The amount of the deficiency determined with respect to the tax imposed by Title I A 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 paid; a statement as to how the deficiency was established, if unpaid, or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and in either case whether it was by closing agreement, Board decision or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date claim for refund was filed and the date the suit was brought; if established by a Board decision or court judgment, a copy thereof shall be attached, together with an explanation of how the decision or judgment became final;
(4) The amount and date of payment of the dividend with respect to which the claim for deficiency dividends credit, or credit or refund, is filed;
(5) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;
(6) The amount claimed as a deficiency dividends credit; and
(7) Such other information as may be required by the claim form.

(d) Time and place of filing claim.—The claim required by section 407 (d) and this article shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 60 days after the date of the closing agreement, or the date upon which the decision of the Board or judgment becomes final, as the case may be.

Anx. 407-6. Effect of deficiency dividends on dividends paid credit.—No duplication of credit allowances with respect to any “deficiency dividends” is permitted. If a corporation claims and receives the benefit of the provisions of section 407 based upon a distribution of “deficiency dividends,” that distribution does not become a part of the basis surtax credit for the purpose of Title I A; nor is it made the basis of the 2% surtax credit for the purposes of Title I B; and nor is it made the basis of any surtax credit for the purposes of Title I C.

Anx. 407-7. Suspension of statute of limitations and stay of collection.—(a) Suspension of running of statute.—If a corporation fails a notification of its intent to have certain dividends considered as “deficiency dividends” as provided in section 407 (c), then the running of the statute of limitations upon the assessment and collection of the established deficiency and all interest, additional amounts, and additions to the tax provided by law, is suspended for a period of two years after the date of the filing of such notification.

(b) Stay of collection.—The Act provides that, except in cases 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 a request to the Commissioner for the prescribed notice of intention to seek the benefit of section
407, the collection of the established deficiency, to the extent of the amount of the credit specified by the corporation in such notification if not in excess of the amount allowable under section 407 (a), is, except in cases of jeopardy, stayed for a period of 60 days subsequent to the final determination of the amount thereof. The filing of a claim for a deficiency dividends credit under section 407 (d) effects a further stay of collection of that portion of the established deficiency covered by the claim if not in excess of the amount allowable under section 407 (a), until the date the claim is disallowed (in whole or in part) by the Commissioner. The Act further provides that where collection has been stayed as above indicated no distraint or proceeding in court shall be begun for the collection of the amount stayed during the period for which it is stayed. The Commissioner, notwithstanding the provisions of section 272 (b), may refrain from assessing the Title IA deficiency (plus interest, additional amounts, and additions to the tax) until the claim for the deficiency dividends credit under section 407 (d) 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 assessed for the deficiency dividends credit to the extent allowed will be credited against the amount so assessed, and the remainder of the amount assessed will be collected in the usual manner.

Sec. 408. Meaning of terms used.—The terms used in this title shall have the same meaning as when used in Title I.

Sec. 409. Administrative provisions.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title IA, shall, so far as not inconsistent with this title, apply in respect of any tax imposed by this title, except that the provisions of section 121 shall not be applicable.

Art. 409—1. Return and payment of tax.—A separate return and payment shall be made in respect of the tax imposed by section 401. Such returns shall be made on Form 1120H. In the case of a personal holding company which is a domestic corporation, the return is required to be made within the time provided by section 55 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 55 and in the case of a foreign corporation within the time provided in section 236. The same provisions of law relating to the period of limitations for assessment and collection which govern the taxes imposed by Title I also apply to the surtax imposed under Title IA. However, so far as the tax imposed by this title does not exceed the tax imposed by Title I, in the making of a return under Title I, the amount of surtax which has been paid under Title IA must be reported. Under Title IA, failure to file a return within the time prescribed under section 601 shall not subject the corporation to any penalty. The term “taxpayer” means any person subject to a tax imposed by this Act.

(b) The terms “includes” and “including” when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.

Art. 901—1. Classification of taxpayers.—For the purpose of taxation the Act makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. See article 901—3. The term “partnership” is not limited to the common law meaning of partnerships, but is broader in its scope and includes groups not commonly called partnerships. See article 901—4. The term “corporation” is not limited to the artificial entity usually known as a corporation, but embraces an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. See articles 901—2 and 901—4. The term “amount” includes all provisions of law, as set forth in section 901, shall have the same respective meaning and scope in these regulations.

Art. 901—2. Association.—The term “association” is not used in the Act in any narrow or technical sense. It includes any organization 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, a business trust, a “Massachusetts” trust, a “common law” trust, an “investment” trust (whether of the fixed or the management type), an insurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

Art. 901—3. Association distinguished from trust.—The term “trust,” as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of trust in favor of some grantor, to the trustees of which title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more
than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company, or a corporate arrangement as an ordinary trust rather than as an association. The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be served and narrowed to the extent 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 beneficiaries and not the fiduciary persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation. However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the undertaking or 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 characteristics 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 characteristics 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 the 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, and other officials to "control" or "operate" the trust; the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form itself. The Act disregards the technical distinction between an ordinary trust and a corporation or an 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 the trust is formed 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 purchase 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.

Ann. 901-4. Partnerships.-The Act provides its own concept of a partnership. Under the term 'partnership' it includes not only an organization as known at common law but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not within the meaning of the Act, a trust, estate, or a corporation. On the other hand the Act classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners, if an organization is not interested in the undertaking by the death of a partner, or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation. As to the characteristics of an association, see also articles 901-2 and 901-3. The following examples will illustrate some phases of these distinctions:

(1) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Act as a partnership. A, B, and C contribute $10,000 each for the purpose of buying and selling real estate. If A, B, C, or D, an outsider 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 or business of the trust and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

Ann. 901-5. Limited partnership as corporation.-Limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Michigan, Pennsylvania, and a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, or having other characteristics of a corporation, in form, must make returns of income and pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized.

Ann. 901-6. Limited partnership as partnership.-Limited partnerships of the type authorized by the statutes of New York and many other States are ordinarily partnerships and not corporations within the meaning of the Act. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes.

Ann. 901-7. Insurance company. Incurance companies are divided into stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of providing 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 subject to State insurance laws are significant in determining the business of a corporation and the tax it intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an
Insurance company under the Act. For example, during the year 1938 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. The M Corporation is not an insurance company for the year 1938 within the meaning of the Act and these regulations.

Art. 901–8. Domestic, foreign, resident, and nonresident persons.—A domestic corporation is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory, and a foreign corporation is one which is not domestic. A domestic corporation is a resident corporation for taxation purposes if it does not own any property in the United States. A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is referred to in these regulations as a resident foreign corporation, and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States or having an office or place of business therein is referred to in these regulations as a resident partnership, and a partnership not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident partnership. Whether a partnership is to be regarded as resident, or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized. The term "nonresident alien," as used in these regulations, includes a nonresident alien individual and a nonresident alien fiduciary.

Art. 901–9. Fiduciary.—"Fiduciary" is a term which applies to persons that occupy positions of peculiar confidence toward others, such as trustees, executors, and guardians. 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 a налогоплательщика. A committee or guardian of the property of an incompetent person is a fiduciary.

Art. 901–10. Fiduciary distinguished from agent.—There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Act. In cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal.

Sec. 902. Separability clause.—If any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provision to all other persons or circumstances, shall not be affected thereby.

Sec. 903. Effective date of act.—Except as otherwise provided, this Act shall take effect upon its enactment. [Received by the President, May 16, 1938.]

Fiduciary distinguished from agent.

APPENDIX

Certain General Provisions of Law and Regulations Applicable to the Tax Imposed on Net Income by Titles I and IA, and of Excess Profits by Title III, of the Revenue Act of 1938, and Certain Provisions of Regulation F of Board of Governors of the Federal Reserve System, Effective December 1, 1937

CONTENTS

Paragraph

Adjudgments of carriers' tax liabilities to conform to recapture payments. Section 1107, Revenue Act of 1932. Administration of conditional affirma-

Section 906, Revenue Act of 1936. 1

Administrative proceedings. Section 1107, Revenue Act of 1932. 2

Bankruptcy proceedings—Cancellation of indebtedness. Sections 229–270, 276c in part: 355, 356, 359 (4); 520–524, 626 (4); 679, 686 (4); Bankruptcy Act of 1938, as amended. 2

Board of Tax Appeals. Date when Board's decision becomes final. Section 1105, Revenue Act of 1932. 16

Expenditures amended. Section 910, Revenue Act of 1924. 19

Fratres proceedings—Burden of proof. Section 912, Revenue Act of 1932, as amended. 12

Preliminary examination. Section 913, Revenue Act of 1932, as amended. 13

Venue. Section 1104, Revenue Act of 1932, as amended. 14, 15

Sections 606, 607, Revenue Act of 1932, as amended. 9

Canadian citizens and corporations, taxation of. Treasury Decision 4893, approved January 16, 1939. 16, 17

Cancellations of indebtedness in bankruptcy proceedings. Sections 288–290, 297e in part: 305, 308, 339 (4); 520–524, 626 (4); 679, 686 (4); Bankruptcy Act of 1898, as amended. 18

Closing agreements. Section 605, Revenue Act of 1932, as amended by sections 601 and 602, Revenue Act of 1938. 19

Collectors of taxes:

Acceptance of Treasury certificates and Treasury notes—Article 1, Treasury Decision 4700, approved November 3, 1936. 19

Section 2, in part, Treasury Decision 4700, approved November 3, 1936. 20

Checks in payment of taxes. Section 1, Act of March 3, 1911 (38 Stat. 656); Act of March 3, 1913 (37 Stat. 733). 21

Enforcement of liability for taxes collected. Section 607, Revenue Act of 1934. 22

Payment of and receipt for taxes. Section 1116, in part, Revenue Act of 1928. 23

Receipts for payment. Section 3183, Revised Statutes, as amended. 24

Suit of restraining order, barred. Section 3224, Revised Statutes. 25

Uncertified checks. Article 18, Revenue Act of 1928, as amended. 26

Common trust funds, national banks. Section 10 (c) and 17, Regulation F, Board of Governors of the Federal Reserve System, effective December 31, 1937. 27

Compromises:

Civil and criminal cases. Section 3229, Revised Statutes, as amended. 29

Concealment of assets. Section 37, Revenue Act of 1926. 30

Courts—Jurisdiction. Section 617, Revenue Act of 1932. 31

Section 1122, Revenue Act of 1920, amending section 32, in part, United States Judicial Code. 32

Deposit of United States bonds or paper in lieu of surety. Section 1125, Revenue Act of 1920, as amended. 33

Disclosure of income-tax returns prohibited. Section 516, Revised Statutes, as amended. 34

Examination of books and witnesses. Section 1104, Revenue Act of 1926, as amended. 35

Transfers. Section 607, Revenue Act of 1934. 36