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CHAPTER I—BUREAU OF INTERNAL REVENUE DEPARTMENT OF THE TREASURY

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Bureau of Old Age and Survivors Insurance, Social Security Administration, Federal Security Agency: See 20 CFR Chapter III.

Food and Drug Administration, Federal Security Agency: See 21 CFR Chapter I.

Immigration and Naturalization Service, Department of Justice: See 8 CFR Chapter I.

Intoxicating Liquors, Bureau of Internal Revenue, Department of the Treasury: See 27 CFR Chapter I.

NOTE: Other regulations issued by the Department of the Treasury appear in Title 12, Chaptr I; Title 19, Chapter I; Title 21, Chapter II; Title 27, Chapter I; Title 31; Title 33, Chapter I; Title 41, Chapter I; Title 46, Chapter I.

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Gauging Manual. Treasury Department Circular No. 808, Treasury Claims Instructions under Federal Tort Claims Act, etc. *The Work and Jurisdiction of the Bureau of Internal Revenue (1948).*

ABBREVIATIONS: The following abbreviations are used in this chapter:

I. R. C.=*Internal Revenue Code.* N. F.=*National Formulary.* T. D.=*Treasury Decision.* USP=*United States Pharmacopoeia.*

SUBCHAPTER A—INCOME AND EXCESS-PROFITS TAXES

Part 7—Taxation Pursuant to Treaties

Subpart—Canada

RELEASE OF EXCESS TAX WITHHELD, AND REDUCTION IN RATE OF WITHHOLDING, UNDER SECTIONS 143 AND 144 OF THE INTERNAL REVENUE CODE IN THE CASE OF RESIDENTS OF CANADA AND OF CORPORATIONS ORGANIZED UNDER THE LAWS OF CANADA, AS AFFECTED BY THE RECIPROCAL TAX CONVENTION BETWEEN THE UNITED STATES AND CANADA, EFFECTIVE JANUARY 1, 1941

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SUBPART—CANADA

RELEASE OF EXCESS TAX WITHHELD, AND REDUCTION IN RATE OF WITHHOLDING, UNDER SECTIONS 143 AND 144 OF THE INTERNAL REVENUE CODE IN THE CASE OF RESIDENTS OF CANADA AND OF CORPORATIONS ORGANIZED UNDER THE LAWS OF CANADA, AS AFFECTED BY THE RECIPROCAL TAX CONVENTION BETWEEN THE UNITED STATES AND CANADA, EFFECTIVE JANUARY 1, 1941

AUTHORITY: §§ 7.10 to 7.17 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791. Interpret or apply 53 Stat. 60, 62, 75, 78, as amended; 26 U. S. C. 143, 144, 211, 231.

SOURCE: §§ 7.10 to 7.17 contained in Treasury Decision 5157, 7 F. R. 4825.

§ 7.10 *Introductory.* (a) The tax convention between the United States and Canada, signed March 4, 1942 and effective January 1, 1941 (referred to in this subpart as the convention), provides in part as follows:

ARTICLE VI

* * * * *

Pensions and life annuities derived from within one of the contracting States and paid to individuals residing in the other contracting State shall be exempt from taxation in the former State.

* * * * *

ARTICLE XI

1. The rate of income tax imposed by one of the contracting States in respect of income derived from sources therein, upon individuals residing in, or corporations organized under the laws of, the other contracting State, and not engaged in trade or business in the former State and having no office or place of business therein, shall not exceed fifteen per cent for each taxable year.

2. Notwithstanding the provisions of paragraph 1 of this Article, income tax in excess of five per cent shall not be imposed by one of the contracting States in respect of dividends paid by a subsidiary corporation organized under the laws of such State, or of a

political subdivision thereof, to a parent corporation organized under the laws of the other contracting State, or of a political subdivision thereof: *Provided however,* That this paragraph shall not apply if the competent authority in the former State is satisfied that the corporate relationship between the two corporations has been arranged or is maintained primarily with the intention of taking advantage of this paragraph.

3. Notwithstanding the provisions of Article XXII of this Convention, paragraph 1 or paragraph 2, or both, of this Article, may be terminated without notice on or after the termination of the three-year period beginning with the effective date of this Convention by either of the contracting States imposing a rate of income tax in excess of the rate of 15 percent prescribed in paragraph 1 or in excess of the rate of 5 percent prescribed in paragraph 2.

4. The provisions of this Article shall not be construed so as to contravene the Tax Convention between the United States of America and Canada, effective January 1, 1936, to April 29, 1941.

* * * * *

ARTICLE XXII

This Convention and the accompanying Protocol which shall be considered to be an integral part of the Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

"This Convention and Protocol shall become effective on the first day of January 1941. They shall continue effective for a period of three years from that date and indefinitely after that period, but may be terminated by either of the contracting States at the end of the three-year period or at any time thereafter: *Provided,* That, except as otherwise specified in the case of Article XI, at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period."

* * * * *

PROTOCOL

* * * * *

6. The term "subsidiary corporation" referred to in Article XI of this Convention means a corporation all of whose shares (less directors' qualifying shares) having full voting rights are beneficially owned by another corporation: *Provided,* That ordinarily not more than one-quarter of the gross income of such subsidiary corporation is derived from interest and dividends other than interest and dividends received from its subsidiary corporations.

(b) Under the terms of the convention, the provisions of which are retroactive to January 1, 1941, the rate of tax of 27½ percent imposed by section 211 (a) of the Internal Revenue Code (relating to nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein) and by section 231 (a) of the Internal Revenue Code (relating to foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein) is reduced to 15 percent in the case of such individuals who are residents of Canada and in the case of such corporations organized under the laws of Canada, with respect to amounts received from sources within the United States as interest (except interest exempt from tax), dividends, rents, salaries, wages, premiums, compensations, remunerations, emoluments or other fixed or determinable annual or periodical gains, profits and income, other than annuities and pensions which are exempt from the tax under the convention. Such tax convention, however, does not affect the rates of tax prescribed under the prior tax convention with Canada, effective January 1, 1936 and terminated effective April 30, 1941. Under such prior convention, the reduced rate of tax with respect to such income, including annuities and pensions, in the case of nonresident aliens, residents of Canada, was 5 percent and in the case of Canadian corporations, 5 percent with respect to dividends only.

§ 7.11 *Release of excess tax withheld at source.* (a) In order to bring the convention into force and effect at the earliest practicable date, the reduced rate of tax of 15 percent to be withheld at the source in the case of nonresident aliens, residents of Canada (including individuals, fiduciaries and partnerships) and of corporations organized under the laws of Canada, with respect to the income enumerated above is hereby made effective beginning January 1, 1942. Accordingly, in the case of such taxpayers, where tax at the rate of 27½ percent has been withheld on or after January 1, 1942, an amount equal to 12½ percent of the income with respect to which such tax has been withheld shall be released by the withholding agent and paid over to the person from whom it was withheld.

(b) Article VI of the convention provides, in part, that pensions and life annuities derived from sources within the United States by nonresident aliens, residents of Canada, shall be exempt from Federal income tax. Accordingly, in any

such case in which the tax has been withheld at the source on such pensions or life annuities on or after January 1, 1942, such tax shall be released by the withholding agent and paid over to the person from whom it was withheld, and such items paid on or after June 27, 1942, to such taxpayers are exempt from withholding.

(c) With respect to a dividend paid on or after January 1, 1942, by a domestic corporation to a corporation organized under the laws of Canada, the tax shall be withheld at the rate of 15 percent unless prior to the date of payment of such dividend the Commissioner has notified the paying corporation that such dividend falls within the provisions of paragraph 2 of Article XI of the convention. Any domestic corporation which claims or contemplates claiming that dividends paid by it come within the provisions of such paragraph shall file, as soon as practicable, with the Commissioner the following information: (1) The date and place of its organization; (2) the number of its outstanding shares of stock having full voting rights; (3) the person or persons beneficially owning such stock and their relation to such corporation; (4) the amount of gross income, by years, of the paying corporation for the three-year period immediately preceding the taxable year in which such dividend is paid; (5) the amount of interest and dividends, by years, included in such gross income and the amount of interest and dividends, by years, received from the subsidiary corporations, if any, of such domestic corporation; and (6) the corporate relationship between such domestic corporation and the Canadian corporation to which it pays the dividend. As soon as practicable after such information is filed, the Commissioner shall examine it and determine whether the dividends concerned fall within the provisions of such paragraph and may authorize the release of excess tax withheld with respect to dividends which are shown to the satisfaction of the Commissioner to come within the provisions of paragraph 2 of Article XI of the convention.

(d) In accordance with section 143 of the Internal Revenue Code (relating to withholding of tax at the source) and section 144 of the Internal Revenue Code (relating to payment of corporation income tax at source), as amended by section 5 and section 202, Revenue Act of 1940, and section 107 of the Revenue Act of 1941, tax at the rate of 16½ percent was required to be withheld at the source with respect to income enumerated above and paid during the period May 15 to September 29, 1941, both dates inclusive, and at the rate of 27½ percent on and after September 30, 1941. Treasury Decision 5046 promulgated May 8, 1941 (6 F. R. 2377), relating to the termination of the reciprocal tax convention between the United States and Canada, effective January 1, 1936, provides that in the case of income paid subsequent to April 29, 1941, and prior to May 15, 1941, the withholding of the tax in the case of nonresident alien individuals, residents of Canada, or corporations organized under the laws of Canada, at the rates applicable under Regulations 103 (26 CFR, 1938 ed., Supps., Part 19) prior to their amendment by Treasury Decision 5046 shall be considered sufficient compliance with the provisions of law any regulations relating to withholding of the tax at the source.

§ 7.12 *Refund of excess tax for 1941.* If the tax paid (whether paid directly or withheld at the source and paid to the Government by the withholding agent) is in excess of the tax due from the taxpayer under the convention, it will be necessary for the taxpayer, in order to compute the tax properly, to file an income tax return, Form 1040NB (Canadians), for individuals and Form 1120NB for corporations, whether or not an income tax return for the year 1941 was filed. In cases where a return has been filed for 1941, the return to be filed under the regulations in this subpart should be marked "Amended." The taxpayer's total fixed or determinable annual or periodical income from sources within the United States for the year 1941 should be reported. In the case of income reported on Form 1040NB (Canadians), the tax on the income should be computed at the rate of 5 percent on income derived during the period January 1 to April 29 and 15 percent on income derived during the period April 30 to December 31, inclusive. In the case of income reported on Form 1120NB, a tax at the rate of 5 percent should be computed on the dividends derived only during the period January 1 to April 29, unless the dividends fall within the scope of paragraph 2 of Article XI of the convention, a tax at the rate of 15 percent being computed on the balance of in-

come reported on the return. There should be filed with such return, in the case of a corporation claiming that the dividends paid by it fall within the provisions of paragraph 2 of Article XI of the convention, the information for 1941 corresponding to that required under the provisions of § 7.11 with respect to the year 1942. Where there has been an overpayment of income tax, claim therefor on Form 843 should accompany the return in order to protect the taxpayers against the running of the statute of limitations provided by section 322 of the Internal Revenue Code. Any tax paid for the year 1941 in excess of that due from the owner of the income will be refunded by the United States Government as required by law.

§ 7.13 *Rate of withholding.* On and after June 27, 1942, withholding in the case of nonresident aliens (including a nonresident alien individual, fiduciary and partnership) residents of Canada and corporations organized under the laws of Canada, not engaged in trade or business in the United States and having no office or place of business therein, shall, except as to dividends falling within the provisions of paragraph 2 of Article XI of the convention, be at the rate of 15 percent.

§ 7.14 *Resident of Canada or corporation organized under the laws of Canada.* (a) For the purpose of withholding, every individual (including a nonresident alien individual, fiduciary, or partnership) whose address is in Canada shall be considered by United States withholding agents as a resident of Canada, and every corporation whose address is in Canada shall be considered by such withholding agents as a corporation organized under the laws of Canada. These provisions relative to Canadian residents and Canadian corporations are based upon the assumption that the payee is the actual owner of the property from which the income is derived and consequently is the person liable to the tax upon such income.

(b) A person receiving income which is distributable to an organization exempt from Federal income tax under section 101 of the Internal Revenue Code shall be considered merely a conduit through which the income flows and not a taxable entity. In preparing ownership certificate, Form 1001, the person receiving the income should make a notation thereon substantially as follows: "As this organization has been held to be exempt from the payment of income tax by the Commissioner of Internal Revenue under date of ———, the interest on this certificate is not subject to withholding", giving the date of the official letter in which the organization was held to be exempt. A similar statement made with respect to other items of fixed or determinable annual or periodical income which are subject to withholding will relieve the withholding agent from liability to withhold the tax.

§ 7.15 *Addressee not actual owner.* (a) If the recipient in Canada is a nominee or agent through whom the income flows to a person who is not entitled to the reduced rate of 15 percent, i. e., a nonresident alien individual who is not a resident of Canada, or a nonresident foreign corporation not organized under the laws of Canada, the recipient in Canada from whom a tax of only 15 percent was withheld becomes in turn a withholding agent, and is required to withhold and remit to the United States Treasury an additional tax equal to 12½ percent of the income prior to diminution by the 15 percent deducted in the United States.

(b) Fiduciaries and partnerships with an address in Canada are liable to have 15 percent income tax deducted at the source. If the fiduciary or partnership is acting as a nominee or agent receiving the income for and on behalf of a person other than a resident of Canada or a corporation organized under the laws of Canada, an additional tax equal to 12½ percent of the income prior to diminution by the 15 percent deducted in the United States must be deducted by such Canadian fiduciary or partnership and remitted to the United States Treasury. If the fiduciary or partnership receives the income in its own right and distributes its income under a trust deed or partnership agreement, then no further tax in Canada need be deducted.

(c) No additional withholding is required with respect to interest on so-called tax-free covenant bonds issued prior to January 1, 1934, where the liability assumed by the obligor exceeds 2 percent but under section 143 (a) of the Internal Revenue Code only 2 percent income tax is required to be withheld at the source. An additional tax of 12½ percent of the income prior to diminution by the 15 percent deducted in the United

States is required to be withheld, however, by Canadian withholding agents as above provided, (1) where the bonds were issued prior to January 1, 1934, and the liability assumed by the obligor does not exceed 2 percent; (2) where the bonds were issued on or after January 1, 1934, irrespective of the liability assumed by the obligor; (3) where the bonds do not contain a tax-free covenant, regardless of the date of issue; and (4) in the case of bonds issued by the United States or any agency or instrumentality thereof on or after March 1, 1941.

§ 7.16 *Return of tax withheld from persons whose addresses are in Canada.* Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, for the calendar year 1942 and each subsequent calendar year, in addition to withholding return, Form 1042, with respect to the items of income from which a tax of 15 percent was withheld from persons whose addresses are in Canada (5 percent in the case of dividends falling within the scope of paragraph 2 of Article XI of the convention). There shall be reported on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns, Form 1012, including items of interest where the liability for withholding is only 2 percent.

§ 7.17 *Returns filed by Canadian withholding agents.* Form 1042 should be prepared annually for the calendar year 1942 and each subsequent calendar year by persons in Canada who receive for the account of any person (other than a resident of Canada or a corporation organized under the laws of Canada) fixed or determinable annual or periodical income from sources within the United States which is subject to tax at the rate of 27½ percent but from which only 15 percent has been withheld as a result of the convention. Such form should contain the names and addresses of all persons whose addresses are outside of Canada and who derive through a nominee, or agent, or custodian in Canada income from sources within the United States. Annual withholding return, Form 1042, should be forwarded to the Collector of Internal Revenue, Baltimore, Maryland, accompanied by the tax shown to be due in United States dollars. An extension of time to June 15 is hereby granted to Canadian withholding agents in which to file such returns for 1942 and subsequent years.

TAXATION OF NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS NOT ENGAGED IN TRADE OR BUSINESS WITHIN THE UNITED STATES AND NOT HAVING AN OFFICE OR PLACE OF BUSINESS THEREIN AS AFFECTED BY THE RECIPROCAL TAX CONVENTIONS BETWEEN THE UNITED STATES AND CANADA

AUTHORITY: §§ 7.20 to 7.39 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791. Interpret or apply 53 Stat. 10, as amended; 26 U. S. C. 22.

SOURCE: §§ 7.20 to 7.39 contained in Treasury Decision 5206, 8 F. R. 66.

§ 7.20 *Introductory.* The tax convention and protocol between the United States and Canada (referred to in this subpart as the convention), proclaimed by the President of the United States on June 17, 1942 and effective January 1, 1941, provides as follows:

ARTICLE I

An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable in accordance with the Articles of this Convention to its permanent establishment in the latter State.

No account shall be taken in determining the tax in one of the contracting States, of the mere purchase of merchandise effected therein by an enterprise of the other State.

ARTICLE II

For the purposes of this Convention, the term "industrial and commercial profits" shall not include income in the form of rentals and royalties, interest, dividends, management charges, or gain derived from the sale or exchange of capital assets.

Subject to the provisions of this Convention such items of income shall be taxed separately or together with industrial and commercial profits in accordance with the laws of the contracting States.

ARTICLE III

1. If an enterprise of one of the contracting States has a permanent establishment in the other State, there shall be attributed to such permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profit will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.

2. The competent authority of the taxing State may, when necessary, in execution of paragraph 1 of this Article, rectify the ac-

counts produced, notably to correct errors and omissions or to reestablish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.

3. If (a) an establishment does not produce an accounting showing its own operations, or (b) the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or (c) the rectifications provided for in paragraph 2 of this Article cannot be effected the competent authority of the taxing State may determine the net industrial and commercial profit by applying such methods or formulae to the operations of the establishment as may be fair and reasonable.

4. To facilitate the determination of industrial and commercial profits allocable to the permanent establishment, the competent authorities of the contracting States may consult together with a view to the adoption of uniform rules of allocation of such profits.

ARTICLE IV

1. (a) When a United States enterprise, by reason of its participation in the management or capital of a Canadian enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which should normally have appeared in the balance sheet of the Canadian enterprise but which have been, in this manner, diverted to the United States enterprise, may be incorporated in the taxable profits of the Canadian enterprise, subject to applicable measures of appeal.

(b) In order to effect the inclusion of such profits in the taxable profits of the Canadian enterprise, the competent authority of Canada may, when necessary, rectify the accounts of the Canadian enterprise, notably to correct errors and omissions or to reestablish the prices or remuneration entered in the books at the values which would prevail between independent persons dealing at arm's length. To facilitate such rectification the competent authorities of the contracting States may consult together with a view to such determination of profits of the Canadian enterprise as may appear fair and reasonable.

2. The same principle applies, mutatis mutandis, in the event that profits are diverted from a United States enterprise to a Canadian enterprise.

ARTICLE V

Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

The present Convention will not be deemed to affect the exchange of notes between the United States of America and Canada, dated August 2 and September 17, 1928, providing for relief from double income taxation on shipping profits.

ARTICLE VI

Wages, salaries and similar compensation paid by the Government, or any agency or instrumentality thereof, of one of the contracting States or by the political subdivisions or territories or possessions thereof to citizens of such State residing in the other State shall be exempt from taxation in the latter State.

Pensions and life annuities derived from within one of the contracting States and paid to individuals residing in the other contracting State shall be exempt from taxation in the former State.

ARTICLE VII

1. A resident of Canada shall be exempt from United States income tax upon compensation for labor or personal services performed within the United States of America if he conforms to either of the following conditions:

(a) He is temporarily present within the United States of America for a period or periods not exceeding a total of one hundred and eighty-three days during the taxable year and such compensation (A) is received for labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Canada and (B) does not exceed $5,000 in the aggregate during such taxable year; or (b) he is temporarily present in the United States of America for a period or periods not exceeding a total of ninety days during the taxable year and the compensation received for such services does not exceed $1,500 in the aggregate during such taxable year.

2. The provisions of paragraph 1 (a) of this Article shall have no application to the professional earnings of such individuals as actors, artists, musicians, and professional athletes.

3. The provisions of paragraphs 1 and 2 of this Article shall apply, mutatis mutandis, to a resident of the United States of America deriving compensation for personal services performed within Canada.

ARTICLE VIII

Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

ARTICLE IX

Students or business apprentices from one of the contracting States residing in the other contracting State for purposes of study or for acquiring business experience shall not be taxable by the latter State in respect of remittances received by them from within the former State for the purposes of their maintenance or studies.

ARTICLE X

Income derived from sources within one of the contracting States by a religious, scientific, literary, educational, or charitable organization of the other contracting State shall be exempt from taxation in the State from which the income is derived if, within the meaning of the laws of both contracting States, such organization would have been exempt from income tax.

ARTICLE XI

1. A resident of Canada shall be exempt of the contracting States, in respect of income derived from sources therein, upon individuals residing in, or corporations organized under the laws of, the other contracting State, and not engaged in trade or business in the former State and having no office or place of business therein, shall not exceed 15 percent for each taxable year.

2. Notwithstanding the provisions of paragraph I of this Article, income tax in excess of 5 percent shall not be imposed by one of the contracting States in respect of dividends paid by a subsidiary corporation organized under the laws of such State, or of a political subdivision thereof, to a parent corporation organized under the laws of the other contracting State, or of a political subdivision thereof: *Provided, however,* That this paragraph shall not apply if the competent authority in the former State is satisfied that the corporate relationship between the two corporations has been arranged or is maintained primarily with the intention of taking advantage of this paragraph.

3. Notwithstanding the provisions of Article XXII of this Convention, paragraph 1 or paragraph 2, or both, of this Article, may be terminated without notice on or after the termination of the three-year period beginning with the effective date of this Convention by either of the contracting States imposing a rate of income tax in excess of the rate of 15 percent prescribed in paragraph 1 or in excess of the rate of 5 percent prescribed in paragraph 2.

4. The provisions of this Article shall not be construed so as to contravene the Tax Convention between the United States of America and Canada, effective January 1, 1936, to April 29, 1941.

ARTICLE XII

Dividends and interest paid on or after the effective date of this Convention by a corporation organized under the laws of Canada to individual residents of Canada, other than citizens of the United States of America, or to corporations organized under the laws of Canada shall be exempt from all income taxes imposed by the United States of America.

ARTICLE XIII

Corporations organized under the laws of Canada, more than 50 percent of the outstanding voting stock of which is owned directly or indirectly throughout the last half of the taxable year by individual residents of Canada, other than citizens of the United States of America, shall be exempt from any taxes imposed by the United States of America with respect to accumulated or undistributed earnings, profits, income or surplus of such corporations. With respect to corporations organized under the laws of Canada not exempt from such taxes under the provisions of this Article the competent authorities of the two contracting States will consult together.

ARTICLE XIV

1. (a) The United States income tax liability for any taxable year beginning prior to January 1, 1936, of any individual resident of Canada, other than a citizen of the United States of America, or of any corporation organized under the laws of Canada, remaining unpaid as of the date of signature of this Convention may be adjusted on a basis satisfactory to the Commissioner: *Provided,* That the amount to be paid in settlement of such liability shall not exceed the amount of the liability which would have been determined if—

(A) the Revenue Act of 1936 as modified by the Tax Convention between the United States of America and Canada, effective January 1, 1936, to April 29, 1941 (except in the case of a corporation organized under the laws of Canada more than 50 percent of the outstanding voting stock of which was owned directly or indirectly throughout the last half of the taxable year by citizens or residents of the United States of America) and

(B) Articles XII and XIII of this Convention had been in effect for such year.

If the taxpayer was not, within the meaning of the Revenue Act of 1936, engaged in trade or business within the United States of America and had no office or place of business therein during the taxable year, the amount of interest and penalties shall not exceed 50 percent of the amount of the tax with respect to which such interest and penalties have been computed.

(b) The United States income tax liability remaining unpaid as of the date of signature of this Convention for any taxable year beginning after December 31, 1935 and prior to January 1, 1941, in the case of any individual resident of Canada, other than a citizen of the United States of America, or in the case of any corporation organized under the laws of Canada shall be determined as if the provisions of Articles XII and XIII of this Convention had been in effect for such year.

2. The provisions of paragraph 1 of this Article shall not apply—

(a) Unless the taxpayer files with the Commissioner within two years from the date of signature of this Convention a request that such tax liability be so adjusted together with such information as the Commissioner may require;

(b) In any case in which the Commissioner is satisfied that any deficiency in tax

is due to fraud with intent to evade the tax.

ARTICLE XV

In accordance with the provisions of Section 8 of the Income War Tax Act as in effect on the day of the entry into force of this Convention, Canada agrees to allow as a deduction from the Dominion income and excess profits taxes on any income which was derived from sources within the United States of America and was there taxed, the appropriate amount of such taxes paid to the United States of America.

In accordance with the provisions of Section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of this Convention, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada.

ARTICLE XVI

Where a taxpayer shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present Convention relates, he shall be entitled to lodge a claim with the State of which he is a citizen or resident or, if the taxpayer is a corporation or other entity, with the State in which it was created or organized. If the claim should be deemed worthy of consideration, the competent authority of such State may consult with the competent authority of the other State to determine whether the double taxation in question may be avoided in accordance with the terms of this Convention.

ARTICLE XVII

Notwithstanding any other provision of this Convention, the United States of America in determining the income and excess profits taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this Convention had not come into effect.

ARTICLE XVIII

The competent authorities of the two contracting States may prescribe regulations to carry into effect the present Convention within the respective States and rules with respect to the exchange of information.

The competent authorities of the two contracting States may communicate with each other directly for the purpose of giving effect to the provisions of the present Convention.

ARTICLE XIX

With a view to the prevention of fiscal evasion, each of the contracting States undertakes to furnish to the other contracting State, as provided in the succeeding Articles of this Convention, the information which its competent authorities have at their disposal or are in a position to obtain under its revenue laws in so far as such information may be of use to the authorities of the other contracting State in the assessment of the taxes to which this Convention relates.

The information to be furnished under the first paragraph of this Article, whether in the ordinary course or on request, may be exchanged directly between the competent authorities of the two contracting States.

ARTICLE XX

1. The competent authorities of the United States of America shall forward to the competent authorities of Canada as soon as practicable after the close of each calendar year the following information relating to such calendar year:

The names and addresses of all persons whose addresses are within Canada and who derive from sources within the United States of America dividends, interest, rents, royalties, salaries, wages, pensions, annuities, or other fixed or determinable annual or periodical profits and income, showing the amount of such profits and income in the case of each addressee.

2. The competent authorities of Canada shall forward to the competent authorities of the United States of America as soon as practicable after the close of each calendar year the following information relating to such calendar year:

(a) The names and addresses of all persons whose addresses are within the United States of America and who derive from sources within Canada, dividends, interest, rents, royalties, salaries, wages, pensions, or other fixed or determinable annual or periodical profits and income, showing the amount of such profits and income in the case of each addressee.

(b) The names and addresses of all persons whose addresses are outside of Canada and who derive through a nominee, or agent, or custodian in Canada income from sources within the United States of America, and who are not entitled to the reduced rate of 15 percent with respect to such income provided in Article XI of this Convention, showing the amount of such income in the case of each addressee.

(c) The names and addresses, where available, of persons whose addresses are outside of Canada and who derive dividends during the calendar year from corporations organized under the laws of Canada, more than 50 percent of the gross income of which is derived from sources within the United States of America, showing the amount of such dividends in each case.

(d) The names and addresses of all persons whose addresses are within the United States of America and who beneficially or of record own stocks or bonds, debentures or other securities, or evidences of funded indebtedness, of any company taxed in Canada as a Non-Resident-Owned Investment Cor-

poration. The term "Non-Resident-Owned Investment Corporation" shall have the same meaning as when used in the Income War Tax Act of Canada.

ARTICLE XXI

1. If the Minister in the determination of the income tax liability of any person under any of the revenue laws of Canada deems it necessary to secure the cooperation of the Commissioner, the Commissioner may, upon request, furnish the Minister such information bearing upon the matter as the Commissioner is entitled to obtain under the revenue laws of the United States of America.

2. If the Commissioner in the determination of the income tax liability of any person under any of the revenue laws of the United States of America deems it necessary to secure the cooperation of the Minister, the Minister, may, upon request, furnish the Commissioner such information bearing upon the matter as the Minister is entitled to obtain under the revenue laws of Canada.

ARTICLE XXII

This Convention and the accompanying Protocol which shall be considered to be an integral part of the Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

This Convention and Protocol shall become effective on the first day of January, 1941. They shall continue effective for a period of three years from that date and indefinitely after that period, but may be terminated by either of the contracting States at the end of the three-year period or at any time thereafter provided that, except as otherwise specified in the case of Article XI, at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

Done in duplicate, at Washington, this fourth day of March, 1942.

[SEAL] SUMNER WELLES
[SEAL] LEIGHTON MCCARTHY.

PROTOCOL

At the moment of signing the Convention for the avoidance of double taxation, and the establishment of rules of reciprocal administrative assistance in the case of income taxes, this day concluded between the United States of America and Canada, the undersigned plenipotentiaries have agreed upon the following provisions and definitions:

1. The taxes referred to in this Convention are:

(a) For the United States of America: the Federal income taxes, including surtaxes, and excess-profits taxes.

(b) For Canada: the Dominion income taxes, including surtaxes, and excess-profits taxes.

2. In the event of appreciable changes in the fiscal laws of either of the contracting States, the Government of the two contracting States will consult together.

3. As used in this Convention:

(a) The terms "person," "individual" and "corporation", shall have the same meanings, respectively, as they have under the revenue laws of the taxing State or the State furnishing the information, as the case may be;

(b) The term "enterprise" includes every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity;

(c) The term "enterprise of one of the contracting States" means, as the case may be, "United States enterprise" or "Canadian enterprise";

(d) The term "United States enterprise" means an enterprise carried on in the United States of America by an individual resident in the United States of America, or by a corporation, partnership or other entity created or organized in or under the laws of the United States of America, or of any of the States or Territories of the United States of America;

(e) The term "Canadian enterprise" is defined in the same manner mutatis mutandis as the term "United States enterprise";

(f) The term "permanent establishment" includes branches, mines and oil wells, farms, timber lands, plantations, factories, workshops, warehouses, offices, agencies and other fixed places of business of an enterprise, but does not include a subsidiary corporation.

When an enterprise of one of the contracting States carries on business in the other contracting State through an employee or agent established there, who has general authority to contract for his employer or principal or has a stock of merchandise from which he regularly fills orders which he receives, such enterprise shall be deemed to have a permanent establishment in the latter State.

The fact that an enterprise of one of the contracting States has business dealings in the other contracting State through a commission agent, broker or other independent agent or maintains therein an office used solely for the purchase of merchandise shall not be held to mean that such enterprise has a permanent establishment in the latter State.

4. The term "Minister", as used in this Convention, means the Minister of National Revenue of Canada or his duly authorized representative. The term "Commissioner", as used in this Convention, means the Commissioner of Internal Revenue of the United States of America, or his duly authorized representative. The term "competent authority", as used in this Convention, means the Commissioner and the Minister and their duly authorized representatives.

5. The term "United States of America", when used in a geographical sense, includes only the States, the Territories of Alaska and

Hawaii, and the District of Columbia. The term "Canada" when used in a geographical sense means the Provinces, the Territories and Sable Island.

6. The term "subsidiary corporation" referred to in Article XI of this Convention means a corporation all of whose shares (less directors' qualifying shares) having full voting rights are beneficially owned by another corporation, provided that ordinarily not more than one-quarter of the gross income of such subsidiary corporation is derived from interest and dividends other than interest and dividends received from its subsidiary corporations.

7. (a) The term "rentals and royalties" referred to in Article II of this Convention shall include rentals or royalties arising from leasing real or immovable, or personal or movable property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using patents, copyrights, secret process and formulae, good will, trade marks, trade brands, franchises and other like property;

(b) The term "interest", as used in this Convention, shall include income arising from interest-bearing securities, public obligations, mortgages, hypothecs, corporate bonds, loans, deposits and current accounts;

(c) The term "dividends", as used in this Convention, shall include all distributions of the earnings or profits of corporations.

8. The term "pensions" referred to in Article VI of this Convention means periodic payments made in consideration for services rendered or by way of compensation for injuries received.

9. The term "life annuities" referred to in Article VI of this Convention means a stated sum payable periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in consideration of a gross sum or sums paid by the recipient or under a contributory retirement plan.

10. The term "'engaged in trade or business" and "office or place of business" as used in Article XI of this Convention shall not be deemed to include an office used solely for the purchase of merchandise.

11. The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit or other allowance accorded by the laws of one of the contracting States in the determination of the tax imposed by such State.

12. The citizens of one of the contracting States residing within the other contracting State shall not be subjected to the payment of more burdensome taxes than the citizens of such other State.

Done in duplicate, at Washington, this fourth day of March, 1942.

[SEAL] SUMNER WELLES
[SEAL] LEIGHTON MCCARTHY

AND WHEREAS the said convention and the said protocol have been duly ratified on both parts and the ratifications of the two Governments were exchanged at Washington on the fifteenth day of June, one thousand nine hundred and forty-two.

AND WHEREAS it is provided in Article XXII of the said convention that the convention and protocol shall become effective on the first day of January, one thousand nine hundred and forty-one;

NOW, THEREFORE, be it known that I, Franklin D. Roosevelt, President of the United States of America, have caused the said convention and the said protocol to be made public to the end that the same and every article, clause and part thereof may be observed and fulfilled with good faith by the United States of America and the citizens thereof.

IN TESTIMONY WHEREOF, I have hereunder set my hand and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this seventeenth day of June, in the year of our Lord one thousand nine hundred and forty-two, and of the Independence of the United States of America the one-hundred and sixty-sixth.

[SEAL] FRANKLIN D ROOSEVELT

By the President:
CORDELL HULL,
Secretary of State.

The Internal Revenue Code provides in *part as follows:*

SEC. 22. GROSS INCOME.

* * * * *

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

* * * * *

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

SEC. 62. RULES AND REGULATIONS.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all rules and regulations for the enforcement of this chapter.

§ 7.21 *Scope of §§ 7.20 to 7.39.* (a) The primary purposes of the convention, to be accomplished on a mutually reciprocal basis are the application of a limited rate of taxation to certain classes of income derived from within one of the contracting States by residents or corporations of the other contracting State, the avoidance of double taxation, the modification of certain taxation provisions with a view to harmonizing as nearly as may be the taxation principles of the two countries, and exchange of fiscal information complementary to other provisions of the convention, including those relating to the avoidance

of double taxation. The convention also lays the basis for facilitating the settlement of pending cases relating to the Federal taxation of residents of Canada, other than citizens of the United States, and of corporations organized under the laws of Canada (referred to in this subpart as Canadian corporations). Sections 7.20 to 7.39 are concerned with the accomplishment of those purposes and with the taxation of nonresident alien residents of Canada and of Canadian corporations.

(b) The specific classes of income from sources within the United States which are exempt by reason of the convention from United States income taxes are:

(1) Industrial and commercial profits of a Canadian enterprise having no permanent establishment in the United States (Article I);

(2) Income derived by a Canadian enterprise from the operation of ships or aircraft registered in Canada (Article V);

(3) Wages, salaries and similar compensations paid by Canada or any agency or instrumentality thereof, or any political subdivision or territory or possession thereof, to citizens of Canada residing in the United States (Article VI);

(4) Pensions and life annuities paid to nonresident alien individuals resident in Canada (Article VI);

(5) Compensaton for labor or personal services performed within the United States by a nonresident alien individual, resident in Canada, such exemption, however, being subject to the limitations set forth in Article VII of the convention and in § 7.28;

(6) Gains derived from the sale or exchange of capital assets by a nonresident alien individual resident in Canada or by a Canadian corporation or other entity having no permanent establishment in the United States (Article VIII);

(7) Remittances from sources within Canada (if and to the extent they constitute gross income) received in the United States by a nonresident alien individual, resident of Canada, who is temporarily resident in the United States for the purposes of study or for acquiring business experience, such remittances being for the purposes of his maintenance or studies (Article IX);

(8) Income of a Canadian religious, scientific, literary, educational or charitable organization (Article X);

(9) Dividends and interest paid on or after January 1, 1941 by a Canadian corporation to individual residents of Canada, other than citizens of the United States, or to Canadian corporations (if and to the extent that such dividends and interest are taxable in the hands of such persons without regard to this convention) (Article XII).

(c) The convention does not, except as provided in the first paragraph of Article VI, affect the liability to United States income tax of Canadian citizens resident in the United States nor does it affect such liability of a citizen of the United States residing in Canada. It has no application to individuals nonresident as to Canada even though such nonresident is a citizen of Canada.

(d) The income tax liability of a nonresident alien individual, resident of Canada, and of a Canadian corporation or other entity, except as to (1) the reduced rate of taxation applicable in the case of such taxpayers and (2) items of income expressly exempted from tax by the convention, is determined in accordance with the provisions of the internal revenue laws of the United States and the regulations thereunder applicable generally to the taxation of nonresident alien individuals and foreign corporations.

§ 7.22 *Definitions.* As used in §§ 7.20 to 7.39:

(a) The term "permanent establishment" includes branches, mines and oil wells, farms, timberlands, plantations, factories, workshops, warehouses, offices, agencies and other fixed places of business of an enterprise. A Canadian parent corporation having a domestic subsidiary corporation in the United States shall not be deemed by reason of such fact to have a permanent establishment in the United States. The mere fact that a foreign subsidiary corporation of a Canadian parent corporation has a permanent establishment in the United States does not mean that such Canadian parent corporation has a permanent establishment in the United States. The fact that a Canadian enterprise has business dealings in the United States through a commission agent, broker or other independent agent or maintains therein an office used solely for the pur-

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chase of merchandise shall not be held to mean that such enterprise has a permanent establishment in the latter State. If, however, the Canadian enterprise carries on business in the United States through an employee or agent established there who has general authority to contract for such Canadian enterprise or has a stock of merchandise located in the United States from which it regularly fills orders, such Canadian enterprise shall be deemed to have a permanent establishment in the United States. The mere fact that salesmen, employees of a Canadian enterprise, promote the sale of its products in the United States or that such enterprise transacts business therein by means of mail order activities does not mean such enterprise has a permanent establishment therein.

(b) The term "enterprise" means any commercial or industrial undertaking whether conducted by an individual, partnership, corporation or other entity. It includes such activities as manufacturing, merchandising, mining and banking. It does not include the rendition of personal services. Hence, a nonresident alien individual, a resident of Canada, rendering personal services within the United States is not, merely by reason of such services, engaged in an enterprise within the meaning of the Convention and his liability to income tax is unaffected by Article I of the convention.

(c) The term "Canadian enterprise" means an enterprise carried on in Canada by a nonresident alien individual resident in Canada or by a Canadian corporation or other Canadian entity. The term "Canadian corporation or other entity" means a partnership, corporation or other entity created or organized in Canada or under the laws of Canada. For example, an enterprise carried on wholly outside Canada by a Canadian corporation is not a Canadian enterprise within the meaning of the convention.

(d) The term "industrial and commercial profits" means the profits arising from the industrial, mercantile, manufacturing, or like activities of a Canadian enterprise as defined in this section. Such term does not include rentals and royalties, interest, dividends, fees or charges for managerial activities or gains derived from the sale or exchange of capital assets, nor compensation for labor or personal services. Such enumerated items of income are not governed by the provisions of Article I but, to the extent covered by the convention, are subject to the rules elsewhere set forth therein and in §§ 7.20 to 7.39.

§ 7.23 *Scope of convention with respect to determination of "industrial and commercial profits" of a nonresident alien individual, resident of Canada, or of a Canadian corporation or other entity carrying on a Canadian enterprise in the United States*—(a) *General.* Article I of the convention adopts the principle that an enterprise of one of the contracting States shall not be taxable in the other contracting State in respect of its industrial and commercial profits unless it has a permanent establishment in the latter State. Hence, a Canadian enterprise is subject to United States tax upon its industrial and commercial profits to the extent of such profits from sources within the United States only if it has a permanent establishment within the United States. From the standpoint of Federal income taxation, the article has application only to a Canadian enterprise and to the industrial and commercial income thereof from sources within the United States. It has no application, for example, to compensation for labor or personal services performed in the United States nor to income derived from real property located in the United States nor to any interest in such property, including rentals and royalties therefrom, nor to gains from the sale or disposition thereof, nor to dividends and interest. Such enumerated items of income, to the extent covered by the convention, are treated separately elsewhere in these regulations and are subject to the rules laid down in the sections having specific reference to the respective items of income. As to what is a "Canadian enterprise", a "permanent establishment" and "industrial and commercial profits", see § 7.22.

(b) *No United States permanent establishment.* A nonresident alien individual, a resident of Canada, or a Canadian corporation or other entity carrying on a Canadian enterprise but having no permanent establishment in the United States is not subject to United States income tax upon industrial and commercial profits from sources within the United States. For example, if such Canadian corporation sells stock in trade, such as ore, or wood pulp, or paper, through a bona fide commission agent or broker in the United States, the resulting

profit is, under the terms of Article I of the convention, exempt from United States income tax. Such Canadian corporation, however, remains subject to tax upon all other items of income from sources within the United States which are not expressly exempted from such tax under the convention. Such Canadian corporation is, however, engaged in trade or business within the United States and hence is not entitled to the reduced rate of 15 percent upon fixed or determinable annual or periodical income as provided in Article XI of the convention. See § 7.31. Such corporation is, however, by reason of its not having a permanent establishment in the United States not subject to tax upon capital gains. See also § 7.29.

(c) *United States permanent establishment.* A nonresident alien individual, resident in Canada, or a Canadian corporation or other entity, carrying on a Canadian enterprise having a permanent establishment in the United States is subject to tax upon industrial and commercial profits from sources within the United States. In the determination of the income of such resident of Canada or Canadian corporation or other entity from sources within the United States, all industrial and commercial profits from such sources shall be deemed to be allocable to the permanent establishment within the United States. Hence, for example, if a Canadian enterprise having a permanent establishment in the United States, sells in the United States through a commission agent therein, goods produced in Canada, the resulting profits derived from United States sources from the latter transactions are allocable to such permanent establishment. In determining such income no account shall be taken of the mere purchase of merchandise effected in the United States by such Canadian enterprise.

§ 7.24 *Allocation of compensation for labor or personal services.* Except as provided in section 119 (a) (3) of the Internal Revenue Code, gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

§ 7.25 *Control of a domestic enterprise by a Canadian enterprise.* Article IV of the convention provides that if a Canadian enterprise by reason of its control of a domestic business imposes conditions different from those which would result from normal business relations between independent enterprises, the accounts between the enterprises will be adjusted so as to ascertain the true net income of the domestic enterprise. The purpose is to place the controlled domestic enterprise on a tax parity with an uncontrolled domestic enterprise by determining, according to the standard of an uncontrolled enterprise, the true net income from the property and business of the controlled enterprise. The convention contemplates that if the accounting records do not truly reflect the net income from the property and business of such domestic enterprise the Commissioner shall intervene and, by making such distributions, apportionments or allocations as he may deem necessary of gross income or deductions of any item or element affecting net income as between such domestic enterprise and the Canadian enterprise by which it is controlled or directed, determine the true net income of the domestic enterprise. The provisions of 26 CFR, 1938 ed., Supps., 19.45-1 (Regulations 103) shall, insofar as applicable, be followed in the determination of the net income of the domestic business.

§ 7.26 *Income from operation of ships or aircraft.* The income derived by a Canadian enterprise from the operation of ships or aircraft registered in Canada is, under Article V of the convention, ex-

empt from United States income tax. However, the profits derived by such enterprise from the operation of ships or aircraft, if any, not so registered are treated as are industrial and commercial profits generally. See Article I of the convention and § 7.23.

§ 7.27 *Wages, salaries and similar compensations, pensions, and life annuities.* (a) Under Article VI of the convention, wages, salaries and similar compensation paid by the Government of Canada or any agency or instrumentality thereof or any political subdivision, or territory thereof, to citizens of Canada residing in the United States are exempt from Federal income tax. The provisions of Article XVII have no application to such income of such individuals. As to the taxation generally of the compensation of employees of foreign governments, see section 116 (h) of the Internal Revenue Code and 26 CFR, 1938 ed., Supps., 19.116–1 (Regulations 103).

(b) Under the provisions of the same article of the convention, pensions and life annuities derived from sources within the United States by nonresident alien individuals residing in Canada are exempt from Federal income tax. Such items of income are, therefore, not subject to the withholding provisions of the Internal Revenue Code. See paragraph 9 of the protocol to the convention as to what constitutes life annuities. However, for the purposes of the convention and §§ 7.20 to 7.29:

(1) The exemption with respect to annuities (other than those paid under a contributory retirement plan) applies only to the individual who has actually paid the consideration upon which the annuity is based; and

(2) The exemption with respect to payments under a contributory retirement plan applies alike to the original beneficiary and to the successor beneficiary even though the latter has not himself actually made payments into the fund from which such payments are made.

(c) See paragraph 8 of the protocol as to what constitutes "pensions" within the meaning of the convention. See section 22 (b) (5), Internal Revenue Code.

§ 7.28 *Compensation for labor or personal services.* (a) Article VII of the convention provides, upon a reciprocal basis, that a nonresident alien, a resident of Canada, is exempt from Federal income tax upon compensation for labor or personal services performed within the United States if he conforms to either of the following conditions: He is temporarily present within the United States for a period or periods:

(1) Not exceeding 183 days during the taxable year and his compensation for labor or personal services performed in the United States during such period (i) is received for labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Canada and (ii) does not exceed $5,000 in the aggregate during such taxable year; or

(2) Not exceeding 90 days during the taxable year and the compensation received for such services does not exceed $1,500 in the aggregate during such taxable year even though such compensation is paid by a United States resident or domestic corporation or other domestic entity.

(b) If, therefore, such nonresident alien individual is temporarily present in the United States for a period or periods in excess of 90 days during the taxable year or receives more than $1,500 in the aggregate during such taxable year for labor or personal services performed in the United States, he is not exempt under paragraph (a) (2) of this section and his right to exemption under the convention will depend on his meeting the following tests:

(1) His stay in the United States is not in excess of 183 days during the taxable year; and

(2) His compensation from United States sources is paid by a Canadian employer; and

(3) Such compensation does not exceed $5,000 in the aggregate during the taxable year.

(c) As to source of compensation for labor or personal services, see § 7.24.

(d) The provisions of paragraph (a) (1) of this section do not extend to the professional earnings of actors, artists, musicians, professional athletes and other individuals engaging in similar pursuits. If, therefore, such latter persons do not come within the provisions of paragraph (a) (2) of this section they are subject to the provisions of the Internal Revenue Code applicable generally to the taxation of nonresident alien individuals.

See section 211, Internal Revenue Code, and regulations thereunder.

§ 7.29 *Capital gains and remittances*—(a) *Capital gains.* Under Article VIII of the convention gain derived from the sale or exchange within the United States of capital assets by a nonresident alien individual resident in Canada by a Canadian corporation or other Canadian entity is exempt from Federal income tax unless such individual, corporation or other entity has a permanent establishment in the United States. As to what constitutes capital assets, see section 117; Internal Revenue Code, and 26 CFR, 1938 ed., Supps., 19.117-1 (Regulations 103). As to what constitutes a permanent establishment, see § 7.22 (a).

(b) *Remittances.* Under Article IX of the convention, nonresident alien individuals, residents of Canada, who are temporarily residing in the United States for the purposes of study or for acquiring business experience are exempt from Federal income tax upon amounts representing remittances from Canada for the purposes of their maintenance and studies if and to the extent such amounts constitute gross income.

§ 7.30 *Exempt organizations.* Article X of the convention provides that religious, scientific, literary, educational or charitable organizations of Canada shall be exempt from Federal taxation with respect to income derived from sources within the United States. Paragraph 11 of the protocol to the convention provides that the provisions of the convention shall not be construed to restrict in any manner any exemption, deduction, credit or other allowance accorded by the laws of one of the contracting States in the determination of the tax imposed by such State. In view of the provisions of paragraph 11, the provisions of section 101 (relating to exemptions from tax on corporations) apply to all Canadian organizations coming within the scope of that section, regardless of whether Canada recognizes such organization as exempt from income and excess profits taxes imposed by that country. The article contemplates that similar exemptions to those granted under the revenue laws of the United States to such organization of Canada will be granted by Canada to a like organization of the United States if any such organization is also a religious, scientific, literary, educational or charitable organization under the laws of Canada, even though such latter organization is nonresident as to Canada. For example, the A Corporation organized under the laws of Canada and conducting no activities in the United States is operated exclusively for religious and charitable purposes and no part of the net earnings of the corporation inures to the benefit of any private shareholders and the corporation meets the other tests of section 101 (6), Internal Revenue Code. The A Corporation is exempt from United States income tax with respect to its income from United States sources. Conversely Article X contemplates that a United States religious or charitable organization similarly circumstanced with respect to Canada shall be exempt from income and excess profits tax otherwise imposed by Canada with respect to income derived by such United States organization from sources in Canada.

§ 7.31 *Reduction in rate of the tax withheld at source*—(a) *General.* (1) Under the terms of the convention, the provisions of which are retroactive to January 1, 1941, the rate of tax of 27½ percent, or 30 percent, as the case may be, imposed by section 211 (a) of the Internal Revenue Code (relating to nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein) and by section 231 (a) of the Internal Revenue Code (relating to foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein) is reduced to 15 percent in the case of such individuals who are residents of Canada and in the case of such corporations organized under the laws of Canada, with respect to amounts received from sources within the United States as interest (except interest exempt from tax), dividends, rents, salaries, wages, premiums, compensations, remunerations, emoluments or other fixed or determinable annual or periodical gains, profits and income, other than annuities and pensions which are exempt from the tax under the convention. Such tax convention, however, does not affect the rates of tax prescribed under the prior tax convention with Canada, effective January 1, 1936, and terminated effective April 30, 1941. Under such prior convention, the reduced rate of tax with respect to such income, including annuities and pensions, in the

case of nonresident aliens, residents of Canada, was 5 percent and in the case of Canadian corporations, 5 percent with respect to dividends only.

(2) Under the provisions of Article XI, dividends paid to a Canadian corporation not engaged in trade or business within the United States and not having an office or place of business therein by a domestic subsidiary corporation are subject to tax at the rate of only 5 percent, such dividends constituting an exception to the general rule laid down in paragraph 1 of Article XI. For the purposes of that article, a "subsidiary corporation" is defined in paragraph 6 of the protocol as a corporation (in this case a domestic corporation) all of whose shares (less directors' qualifying shares) having full voting rights are beneficially owned by another corporation (in this case a Canadian corporation: *Provided,* That ordinarily not more than one-quarter of the gross income of such subsidiary corporation is derived from interest and dividends other than interest and dividends received from its subsidiary corporations. Thus, for example, the A Corporation is a domestic corporation all of whose shares are owned by B Company, Ltd., a Canadian corporation not engaged in trade or business within the United States and not having any office or place of business therein. The A Corporation pays a dividend to B Company, Ltd., on June 30, 1943. The A Corporation is on a calendar year basis and throughout 1940, 1941 and 1942 derived not more than 15 percent of its gross income from interest and dividends from corporations not controlled by the A Corporation. The Commissioner ascertains and has so notified the A Corporation that the corporate relationship between the A Corporation and the B Company, Ltd., has not been arranged and is not maintained primarily for the purpose of securing the lower rate of tax prescribed in paragraph 2 of Article XI of the convention. The dividend paid by the A Corporation is subject to withholding of the tax at the lower rate of 5 percent.

(3) Any domestic corporation which claims or contemplates claiming, that dividends paid by it, or to be paid by it, are subject only to the 5 percent rate, shall file, as soon as practicable, with the Commissioner the following information: (i) The date and place of its organization; (ii) the number of its outstanding shares of stock having full voting rights; (iii) the person or persons beneficially owning such stock and their relationship to such corporation; (iv) the amount of gross income by years of the paying corporation for the three-year period immediately preceding the taxable year in which such dividend is paid; (v) the amount of interest and dividends, by years, included in such gross income and the amount of interest and dividends, by years, received from the subsidiary corporations, if any, of such domestic corporation; and (vi) the corporate relationship between such domestic corporation and the Canadian corporation to which it pays the dividend. As soon as practicable after such information is filed, the Commissioner shall examine it and determine whether the dividends concerned fall within the provisions of such paragraph and may authorize the release of excess tax withheld with respect to dividends which are shown to the satisfaction of the Commissioner to come within the provisions of paragraph 2 of Article XI of the convention. In any case in which the Commissioner has notified such domestic corporation that it comes within the provisions of paragraph 2 of Article XI of the convention, the reduced rate of 5 percent applies to any dividends subsequently paid by such corporation unless its stock ownership or the character of its income materially changes. In the event of such changes occurring, such corporation shall promptly notify the Commissioner of the then existing facts with respect to such stock ownership and income.

(b) *Specific terms.* (1) Under paragraph 7 (b) of the protocol, the term "interest" as used in the convention includes income arising from interest-bearing securities, public obligations mortgages, hypothecs, corporate bonds, loans, deposits and current accounts. The term "dividends" as used in the convention includes all distributions of the earnings or profits of corporations. The term "rentals and royalties" as used in Article II of the convention includes rentals or royalties arising from leasing real or immovable, or personal or movable property, or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes, and formulae, goodwill, trade marks, trade brands, franchises and other like property.

(2) By reason of the provisions of paragraph 11 of the protocol, nonresident aliens, residents of Canada, and Canadian corporations and other Canadian entities are entitled to any exemption, deduction, credit, or other allowance or reliefs accorded by the revenue laws of the United States to nonresident alien individuals and foreign corporations generally. If, therefore, the terms "interest", "dividends" and "rentals and royalties" as used in the convention include items not subject to Federal tax, such latter items remain nontaxable under the convention.

(3) As to refund of tax withheld for 1941 in excess of the rates provided in the convention, application of the reduced rate of withholding under the convention, and instructions with respect to United States and Canada withholding agents as to withholding of the tax and the filing of returns by such withholding agents, see §§ 7.10 to 7.17.

§ 7.32 *Dividends and interest paid by Canadian corporations.* (a) A dividend paid by a foreign corporation constitutes income from sources within the United States, and hence is subject to tax in the hands of nonresident alien or foreign corporations, if 50 percent or more of the gross income of the foreign corporation paying such dividend is derived from sources within the United States during the period prescribed by the statute. Section 119 (a) (2) (B), Internal Revenue Code and 26 CFR, 1938 ed., Supps., 19.119-3 (b) (Regulations 103). Interest paid by a resident foreign corporation constitutes income from sources within the United States, and hence is subject to tax in the hands of a nonresident alien individual or foreign corporation, if 20 percent or more of the gross income of the foreign corporation paying such interest is derived from sources within the United States during the period prescribed by the statute. Section 119 (a) (1) (B), Internal Revenue Code and 26 CFR, 1938 ed., Supps., 19.119-2 (b) (Regulations 103).

(b) Under the provisions of Article XII of the convention, dividends and interest paid by a Canadian corporation to a nonresident alien resident in Canada, or to another Canadian corporation are not subject to Federal income tax regardless of whether the corporation paying such dividend or interest is a resident foreign (as to the United States) corporation and regardless of the percentage of its gross income derived from sources within the United States, and regardless further of whether such resident of Canada is a Canadian citizen. However, such dividends and interest still remain income from sources within the United States if the conditions prescribed in the cited sections of the Internal Revenue Code are met. Such dividends and interest, to the extent they constitute income from sources within the United States, are, therefore, taken into consideration in ascertaining whether the dividends and interest paid by the recipient Canadian corporation in turn constitute income from sources within the United States for the purpose of taxation of nonresident alien individuals, nonresident as to Canada, and of foreign corporations, other than Canadian corporations. If, for example, the A Company, Ltd., a Canadian corporation, derives 75 percent of its gross income in the form of dividends from the B Company, Ltd., another Canadian corporation which derives all of its gross income from sources within the United States, such dividends from the B Company, Ltd., to the A Company, Ltd., are exempt from Federal income tax in the hands of the A Company, Ltd. However, any dividend paid by the A Company, Ltd., to a nonresident alien individual, nonresident as to Canada, or to a foreign corporation, other than a Canadian corporation, is subject to Federal income tax as constituting income from sources within the United States to the extent provided in section 119 (a) (2) (B), Internal Revenue Code and regulations thereunder.

§ 7.33 *Canadian corporations; exemptions from Federal taxation with respect to accumulated surplus or undistributed income.* (a) Section 102 of the Internal Revenue Code imposes (in addition to other taxes imposed by chapter 1 of such Code) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. Such tax, however, does not apply in the case of personal holding companies as defined in section 501 of the Internal Revenue Code nor to foreign personal holding companies as defined in Supplement B (sec-

tion 331) of such Code. Section 500 of the Internal Revenue Code imposes (in addition to the taxes imposed by chapter 1 of such Code) a graduated income tax or surtax upon corporations classified as personal holding companies, regardless of whether or not they are formed or availed of to accumulate earnings or profits for the purpose of avoiding surtax upon shareholders. A foreign corporation, whether resident or nonresident, classified as a personal holding company under section 501 (not including a foreign personal holding company as defined in section 331) is subject to the tax imposed by section 500 with respect to its income from sources within the United States even though such income is not fixed or determinable annual or periodical income specified in section 231 (a).

(b) Under the provisions of Article XIII of the convention, Canadian corporations are subject to neither the tax imposed by section 102, supra, nor the tax imposed by section 500, supra, if more than 50 percent of the outstanding voting stock of such corporation is owned directly or indirectly throughout the last half of the taxable year by nonresident alien individuals, residents of Canada. To come within the scope of the exemption, the prescribed proportion of the stock of the Canadian corporation concerned must be so owned at all times throughout the last half of the taxable year in which the taxable status of the corporation is involved. In determining the ownership of the voting stock of the Canadian corporation, the provisions of Regulations 103 (26 CFR, 1938 ed. Supps., 19.503 (a) (1)–(7), (b) (1)), shall, insofar as not inconsistent with the convention, be applicable in the administration of the provisions of the convention.

§ 7.34 *Adjustment of tax liability of Canadians for 1940 and prior years.* (a) Article XIV (1) confers upon the Commissioner authority to adjust the tax liability for 1935 and prior taxable years of nonresident aliens, residents of Canada, and Canadian corporations in any case in which such tax liability remained unpaid as at the date of the signing of the convention, March 4, 1942. Such provision, however, will not apply in any case unless:

(1) The Commissioner is satisfied that the additional income tax involved did not arise by reason of fraud with intent to evade the tax on the part of the taxpayer concerned and

(2) The taxpayer files with the Commissioner a notarized statement showing for each year involved and for such other years as the Commissioner may require, (i) by items and classes of income the amounts of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical income, gains, profits and income derived from sources within the United States; (ii) the business transactions, if any, carried on in the United States by or in behalf of the taxpayer during each of such years and (iii) such further information as the Commissioner may require in the particular case.

(b) In any case in which the Commissioner deems it appropriate to exercise the authority thus conferred, the resulting tax liability for any such year or years may not exceed the amount of the liability which would have been determined had the following been taken into effect for such year or years:

(1) The Revenue Act of 1936 as modified by the tax convention between the United States and Canada, effective January 1, 1936, to April 29, 1941 but this does not apply in the case of a corporation organized under the laws of Canada, more than 50 percent of the outstanding voting stock of which was owned directly or indirectly throughout the last half of the taxable year by citizens or residents of the United States;

(2) Article XII of the convention exempting from United States tax dividends and interest paid by a Canadian corporation to individual residents of Canada or to corporations organized under the laws of Canada; (see § 7.32) and

(3) Article XIII of the convention exempting Canadian corporations from the tax imposed by the United States with respect to accumulated or undistributed earnings and profits, income or surplus (see § 7.33).

(c) In any case in which the Commissioner has exercised his authority to apply the provisions of Article XIV (1) (a) of the convention, the aggregate amount of interest and penalties cannot exceed 50 percent of the amount of the tax with respect to which such interest and penalties have been computed, if in such case the taxpayer was not engaged in trade

or business within the United States and had no office or place of business therein during the taxble year involved.

(d) Article XIV (b) of the convention provides that the Federal income tax liability remaining unpaid as at March 4, 1942, the date of signature of the Convention, for taxable years beginning after December 31, 1935, and prior to January 1, 1941, in the case of any nonresident alien individual, a resident of Canada, or a Canadian corporation shall be determined under the United States internal revenue laws properly applicable thereto, except that Article XII and Article XIII of the convention shall be treated as being in effect for such year. (See §§ 7.32 and 7.33.) Since for such years the income tax laws properly applicable thereto are modified by the tax convention between the United States and Canada effective January 1, 1936, there exists no necessity to make application to the Commissioner for the adjustment of the tax liability for such years on such basis.

§ 7.35 *Credit against United States tax liability for income tax paid to Canada.* For the purpose of avoidance of double taxation Article XV provides that, on the part of the United States, there shall be allowed against the United States income and excess profits tax liability a credit for any such taxes paid to Canada by United States citizens or domestic corporations. Such principle also applies in the case of a citizen of Canada residing in the United States. Such credit, however, is subject to the limitations provided in section 131, Internal Revenue Code (relating to the credit for foreign taxes). See 26 CFR, 1938 ed., Supps., 19.131-1 to 19.131-8 (Regulations 103). The article is complementary to the provisions of Article XVII, which provides that the United States in ascertaining the income and excess profits tax of its citizens and residents and corporations may take into the basis upon which such taxes are imposed all items of income as though the convention had not come into effect.

§ 7.36 *Reciprocal regulations.* Article XVIII contemplates that both the United States and Canada may prescribe regulations for the purpose of carrying the convention into effect within the respective countries and reciprocal rules relating to the exchange of information and that in the formulation of such regulations and rules the Commissioner and the Minister may communicate with each other directly and outside diplomatic channels. See paragraph 4 of the Protocol of the Convention. As used in §§ 7.20 to 7.39 the term "Commissioner" means Commissioner of Internal Revenue or his duly authorized representative, and the term "Minister" means the Minister of National Revenue of Canada or his duly authorized representative. See § 7.24 relating to allocation of income.

§ 7.37 *Reciprocal administrative assistance.* (a) By Article XIX of the convention, the United States and Canada adopt the principle of exchange of information for use in the determination and assessment of the taxes with which the convention is concerned. See § 7.36. Pursuant to such principle, every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, for the calendar year 1942 and each subsequent calendar year, in addition to withholding return, Form 1042, with respect to the items of income from which a tax of 15 percent was withheld from persons whose addresses are in Canada (5 percent in the case of dividends falling within the scope of paragraph 2 of Article XI of the convention). There shall be reported on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns, Form 1012, including items of interest where the liability for withholding is only 2 percent.

(b) The information and correspondence relative to exchange of information may be transmitted directly by the Commissioner to the Minister.

§ 7.38 *Information to be furnished in due course.* In accordance with the provisions of Article XX (1) of the convention, the Commissioner shall forward to the Minister as soon as practicable after the close of the calendar year 1942 and of each calendar year thereafter during which the convention is in effect the names and addresses of all persons whose addresses are within Canada and who derive from sources within the United States, dividends, interest, rents, royalties, salaries, wages, pensions, and annuities or other fixed or determinable annual or periodical profits and income, showing the amounts of such profits and income in the case of each addressee. For these purposes, the transmission to the Minister of Information Return, Form 1042B, as provided in § 7.37 for the calendar year 1942 and subsequent calendar years shall constitute a compli-

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ance with the provisions of Article XX (1) of the convention and of §§ 7.20 to 7.39.

§ 7.39 *Information in specific cases.* Under the provisions of Article XXI of the convention and upon request of the Minister, the Commissioner may furnish to the Minister any information available to, or obtainable by, the Commissioner under the revenue laws relative to the tax liability of any person (whether or not a citizen or resident of Canada) under the revenue laws of Canada.

SUBPART—SWEDEN

AUTHORITY: §§ 7.200 to 7.218 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 7.200 to 7.218 contained in Treasury Decision 4975, 5 F. R. 2400.

§ 7.200 *Introductory.* (a) The tax convention and protocol between the United States and Sweden, referred to in this subpart as the convention, proclaimed by the President of the United States on December 12, 1939, and effective January 1, 1940, provides as follows:

ARTICLE I

The taxes referred to in this Convention are:

(a) In the case of the United States of America:

(1) The Federal income taxes, including surtaxes and excess-profits taxes.

(2) The Federal capital stock tax.

(b) In the case of Sweden:

(1) The National income and property tax, including surtax.

(2) The National special property tax.

(3) The communal income tax.

It is mutually agreed that the present Convention shall also apply to any other or additional taxes imposed by either contracting State, subsequent to the date of signature of this Convention, upon substantially the same bases as the taxes enumerated herein.

The benefits of this Convention shall accrue only to citizens and residents of the United States of America, to citizens and residents of Sweden and to United States or Swedish corporations and other entities.

ARTICLE II

An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in the latter State. The income thus taxed in the latter State shall be exempt from taxation in the former State.

No account shall be taken, in determining the tax in one of the contracting States, of the mere purchase of merchandise effected therein by an enterprise of the other State.

The competent authorities of the two contracting States may lay down rules by agreement for the apportionment of industrial and commercial profits.

ARTICLE III

When an enterprise of one of the contracting States, by reason of its participation in the management or capital of an enterprise of the other contracting State, makes or imposes on the latter in their commercial or financial relations conditions different from those which would be made with an independent enterprise, any profits which should normally have appeared in the balance sheet of the latter enterprise but which have been in this manner diverted to the former enterprise may, subject to applicable measures of appeal, be incorporated in the taxable profits of the latter enterprise. In such case consequent rectifications may be made in the accounts of the former enterprise.

ARTICLE IV

Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State is taxable only in the State in which registered. Income derived by such an enterprise from the operation of ships or aircraft not so registered shall be subject to the provisions of Article II.

ARTICLE V

Income of whatever nature derived from real property, including gains derived from the sale of such property, but not including interest from mortgages or bonds secured by real property, shall be taxable only in the contracting State in which the real property is situated.

ARTICLE VI

Royalties from real property or in respect of the operation of mines, quarries, or other natural resources shall be taxable only in the contracting State in which such property, mines, quarries, or other natural resources are situated.

Other royalties and amounts derived from within one of the contracting States by a resident or by a corporation or other entity of the other contracting State as consideration for the right to use copyrights, patents, secret processes and formulas, trademarks and other analogous rights, shall be exempt from taxation in the former State.

ARTICLE VII

1. Dividends shall be taxable only in the contracting State in which the shareholder is resident or, if the shareholder is a corporation or other entity, in the contracting State in which such corporation or other entity is created or organized; provided, however, that each contracting State reserves the right to collect and retain (subject to applicable provisions of its revenue laws) the taxes which, under its revenue laws, are deductible at the

source, but not in excess of 10 per centum of the amount of such dividends. For the purposes of this Article the National income and property tax imposed by Sweden shall be deemed to be a tax deducted at the source.

2. Notwithstanding the provisions of Article XXII of this Convention, the provisions of this Article may be terminated by either of the contracting States at the end of two years from the date upon which this Convention enters into force or at any time thereafter, provided at least six months' prior notice of termination is given, such termination to become effective on the first day of January following the expiration of such six-month period. In the event the provisions of this Article are terminated, the provisions of—

(1) Article XIII (2), in so far as they relate to the special property tax imposed by Sweden upon shares in a corporation;

(2) Article XIV (b) (2), relating to the allowance of an additional deduction from taxes on dividends; and

(3) Article XVI, in so far as they relate to exchange of information with respect to dividends,

will likewise terminate.

ARTICLE VIII

Interest on bonds, notes, or loans shall be taxable only in the contracting State in which the recipient of such interest is a resident or, in the case of a corporation or other entity, in the State in which the corporation or other entity is created or organized; *Provided, however,* That each contracting State reserves the right to collect and retain (subject to applicable provisions of its revenue laws) the taxes which, under its revenue laws, are deductible at the source.

ARTICLE IX

Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

ARTICLE X

Wages, salaries and similar compensation and pensions paid by one of the contracting States or by the political subdivisions or territories or possessions thereof to individuals residing in the other State shall be exempt from taxation in the latter State.

Private pensions and life annuities derived from within one of the contracting States and paid to individuals residing in the other contracting State shall be exempt from taxation in the former State.

ARTICLE XI

(a) Compensation for labor or personal services, including the practice of the liberal professions, shall be taxable only in the contracting State in which such services are rendered.

(b) The provisions of paragraph (a) are, however, subject to the following exceptions:

A resident of Sweden shall be exempt from United States tax upon compensation for labor or personal services performed within the United States of America if he falls within either of the following classifications:

1. He is temporarily present within the United States of America for a period or periods not exceeding a total of one hundred eighty days during the taxable year and his compensation is received for labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Sweden; or

2. He is temporarily present in the United States of America for a period or periods not exceeding a total of ninety days during the taxable year and the compensation received for such services does not exceed $3,000.00 in the aggregate.

In such cases Sweden reserves the right to the taxation of such income.

(c) The provisions of paragraph (b) of this Article shall apply, mutatis mutandis, to a resident of the United States of America deriving compensation for personal services performed within Sweden.

(d) The provisions of paragraphs (b) and (c) of this Article shall have no application to the professional earnings of such individuals as actors, artists, musicians and professional athletes.

(e) The provisions of this Article shall have no application to the income to which Article X relates.

ARTICLE XII

Students or business apprentices from one contracting State residing in the other contracting State exclusively for purposes of study or for acquiring business experience shall not be taxable by the latter State in respect of remittances received by them from within the former State for the purposes of their maintenance or studies.

ARTICLE XIII

(1) If the property consists of:

(a) Immovable property and accessories appertaining thereto;

In the case of taxes on property or increment of property the following provisions shall be applicable:

(b) Commercial or industrial enterprises, including maritime shipping and air transport undertakings;

the tax may be levied only in that contracting State which is entitled under the preceding Articles to tax the income from such property.

(2) In the case of all other forms of property, the tax may be levied only in that contracting State where the taxpayer has his

residence or, in the case of a corporation or other entity, in the contracting State where the corporation or other entity has been created or organized.

The same principles shall apply to the United States capital stock tax with respect to corporations of Sweden having capital or other property in the United States of America.

ARTICLE XIV

It is agreed that double taxation shall be avoided in the following manner:

(a) Notwithstanding any other provision of this Convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens or residents or corporations may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this Convention had not come into effect. The United States of America shall, however, deduct the amount of the taxes specified in Article I (b) (1) and (3) of this Convention or other like taxes from the income tax thus computed but not in excess of that portion of the income tax liability which the taxpayer's net income taxable in Sweden bears to his entire net income.

(b) (1) Notwithstanding any other provision of this Convention, Sweden, in determining the graduated tax on income and property of its residents or corporations or other entities, may include in the basis upon which such tax is imposed all items of income and property subject to such tax under the taxation laws of Sweden. Sweden shall, however, deduct from the tax so calculated that portion of such tax liability which the taxpayer's income and property exempt from taxation in Sweden under the provisions of this Convention bears to his entire income and property.

(2) There shall also be allowed by Sweden from its National income and property tax a deduction offsetting the tax deducted at the source in the United States of America, amounting to not less than 5 per centum of the dividends from within the United States of America and subject to such tax in Sweden. It is agreed that the United States of America shall allow a similar credit against the United States income tax liability of citizens of Sweden residing in the United States of America.

ARTICLE XV

With a view to the more effective imposition of the taxes to which the present Convention relates, each of the contracting States undertakes, subject to reciprocity, to furnish such information in the matter of taxation, which the authorities of the State concerned have at their disposal or are in a position to obtain under their own law, as may be of use to the authorities of the other State in the assessment of the taxes in question and to lend assistance in the service of documents in connection therewith. Such information and correspondence relating to the subject matter of this Article shall be exchanged between the competent authorities of the contracting States in the ordinary course or on demand.

ARTICLE XVI

1. In accordance with the preceding article, the competent authorities of the United States of America shall forward to the competent authorities of Sweden as soon as practicable after the close of each calendar year the following information relating to such calendar year:

(a) The names and addresses of all addressees within Sweden deriving from sources within the United States of America dividends, interest, royalties, pensions, annuities, or other fixed or determinable annual or periodical income, showing the amount of such income with respect to each addressee;

(b) Any particulars which the competent United States authorities may obtain from banks, savings banks or other similar institutions concerning assets belonging to individuals resident in Sweden or to Swedish corporations or other entities;

(c) Any particulars which the competent United States authorities may obtain from inventories in the case of property passing on death concerning debts contracted with individuals resident in Sweden or Swedish corporations or other entities.

2. The competent authorities of Sweden shall forward to the competent authorities of the United States of America as soon as practicable after the close of each calendar year the following information relating to such calendar year:

(a) The particulars contained in the forms delivered to the Swedish authorities in connection with the payment to individuals or corporations or other entities whose addresses are within the United States of America of dividends on shares in a corporation or participation certificates in cooperative societies, and interest on bonds or other similar securities;

(b) The particulars contained in permits accorded to individuals resident in the United States of America or to United States corporations or other entities to enable them to acquire for business purposes immovable property situated in Sweden;

(c) Any particulars which the central Swedish authorities may obtain from banks, savings banks or other similar institutions concerning assets belonging to individuals resident in the United States of America or to United States corporations or other entities;

(d) Any particulars which the central Swedish authorities may obtain from inventories in the case of property passing on death, concerning debts contracted with individuals resident of the United States of America, or United States corporations or other entities;

(e) A list of the names and addresses of all United States citizens resident in the United States of America who have made declarations to the Central Committee in Stockholm in charge of the taxation of taxpayers not resident in Sweden for purposes of the Swedish tax on income and property;

(f) Particulars concerning annuities and pensions, public or private, paid to individuals resident in the United States of America.

ARTICLE XVII

Each contracting State undertakes, in the case of citizens or corporations or other entities of the other contracting State, to lend assistance and support in the collection of the taxes to which the present Convention relates, together with interest, costs, and additions to the taxes and fines not being of a penal character. The contracting State making such collection shall be responsible to the other contracting State for the sums thus collected.

In the case of applications for enforcement of taxes, revenue claims of each of the contracting States which have been finally determined shall be accepted for enforcement by the other contracting State and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes. The State to which application is made shall not be required to enforce executory measures for which there is no provision in the law of the State making the application.

The applications shall be accompanied by such documents as are required by the laws of the State making the application to establish that the taxes have been finally determined.

If the revenue claim has not been finally determined the State to which application is made may, at the request of the other contracting State, take such measures of conservancy as are authorized by the revenue laws of the former State.

ARTICLE XVIII

The competent authority of each of the contracting States shall be entitled to obtain, through diplomatic channels, from the competent authority of the other contracting State, particulars in concrete cases relative to the application to citizens or to corporations or other entities of the former State, of the taxes to which the present Convention relates. With respect to particulars in other cases, the competent authority of each of the contracting States will give consideration to requests from the competent authority of the other contracting State.

ARTICLE XIX

In no case shall the provisions of Article XVII, relating to mutual assistance in the collection of taxes, or of Article XVIII, relating to particulars in concrete cases, be construed so as to impose upon either of the contracting States the obligation

(1) to carry out administrative measures at variance with the regulations and practice of either contracting State, or

(2) to supply particulars which are not procurable under its own legislation or that of the State making application.

The State to which application is made for information or assistance shall comply as soon as possible with the request addressed to it. Nevertheless, such State may refuse to comply with the request for reasons of public policy or if compliance would involve violation of a business, industrial or trade secret or practice. In such case it shall inform, as soon as possible, the State making the application.

ARTICLE XX

Where a taxpayer shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present Convention relates, he shall be entitled to lodge a claim with the State of which he is a citizen or, if he is not a citizen of either of the contracting States, with the State of which he is a resident, or, if the taxpayer is a corporation or other entity, with the State in which it is created or organized. Should the claim be upheld, the competent authority of such State may come to an agreement with the competent authority of the other State with a view to equitable avoidance of the double taxation in question.

ARTICLE XXI

The competent authorities of the two contracting States may prescribe regulations necessary to interpret and carry out the provisions of this Convention. With respect to the provisions of this Convention relating to exchange of information, service of documents and mutual assistance in the collection of taxes, such authorities may, by common agreement, prescribe rules concerning matters of procedure, forms of application and replies thereto, conversion of currency, disposition of amounts collected, minimum amounts subject to collection and related matters.

ARTICLE XXII

The present Convention shall be ratified, in the case of the United States of America, by the President, by and with the advice and consent of the Senate, and in the case of Sweden, by His Majesty the King, with the consent of the Riksdag. The ratifications shall be exchanged at Stockholm.

This Convention shall become effective on the first day of January following the exchange of the instruments of ratification and shall apply to income realized and property held on or after that date. The Convention shall remain in force for a period of five years and indefinitely thereafter but may be terminated by either contracting State at the end of the five-year period or at any time thereafter, provided at least six months' prior no-

tice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

In witness whereof the respective Plenipotentiaries have signed this Convention and have affixed their seals hereto.

Done in duplicate, in the English and Swedish languages, both authentic, at Washington, this twenty-third day of March, nineteen hundred and thirty-nine.

For the President of the United States of America:

SUMNER WELLES [SEAL]

For His Majesty the King of Sweden:

W. BOSTRÖM [SEAL]

PROTOCOL

At the moment of signing the Convention for the avoidance of double taxation, and the establishment of rules of reciprocal administrative assistance in the case of income and other taxes, this day concluded between the United States of America and Sweden, the undersigned Plenipotentiaries have agreed that the following provisions shall form an integral part of the Convention:

1. As used in this Convention:

(a) The term "permanent establishment" includes branches, mines and oil wells, plantations, factories, workshops, warehouses, offices, agencies, installations, and other fixed places of business of an enterprise but does not include the casual or temporary use of merely storage facilities. A parmanent establishment of a subsidiary corporation shall not be deemed to be a permanent establishment of the parent corporation. When an enterprise of one of the contracting States carries on business in the other State through an employee or agent, established there, who has general authority to contract for his employer or principal, it shall be deemed to have a permanent establishment in the latter State. But the fact that an enterprise of one of the contracting States has business dealings in the other State through a bona fide commission agent, broker or custodian shall not be held to mean that such enterprise has a permanent establishment in the latter State.

(b) The term "enterprise" includes every form of undertaking whether carried on by an individual, partnership, corporation, or any other entity.

(c) The term "enterprise of one of the contracting States" means, as the case may be, "United States enterprise" or "Swedish enterprise".

(d) The term "United States enterprise" means an enterprise carried on in the United States of America by a resident of the United States of America or by a United States corporation or other entity; the term "United States corporation or other entity" means a partnership, corporation or other entity created or organized in the United States of America or under the law of the United States of America or of any State or Territory of the United States of America.

(e) The term "Swedish enterprise" is defined in the same manner, mutatis mutandis, as the term "United States enterprise".

2. The term "corporation" includes associations, joint-stock companies, and insurance companies.

3. A citizen of one of the contracting States not residing in either shall be deemed, for the purpose of this Convention, to be a resident of the contracting State of which he is a citizen.

When doubt arises with respect to residence or with respect to the taxable status of corporations or other entities, the competent authorities of the two contracting States may settle the question by mutual agreement.

4. The provisions of Swedish law concerning the taxation of the undivided estates of deceased persons shall not apply where the beneficiaries are directly liable to taxation in the United States of America.

5. The term "life annuities" referred to in Article X of this Convention means a stated sum payable periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in consideration of a gross sum paid for such obligation.

6. The Swedish so-called "fees tax" (bevillingsavgift for vissa offentliga forestallningar) based on gross income in so far as it affects such individuals as actors, artists, musicians and professional athletes shall be deemed to be an income tax for the purposes of Article XIV (a).

The credit for taxes provided in Article XIV shall have no application to taxes deducted at the source from dividends and interest except to the extent provided in paragraph (b) (2) of that Article.

In the application of the provisions of this Convention the benefits of section 131 of the United States Revenue Act of 1938, relating to credits for foreign taxes shall be accorded but the credit provided for in Article XIV (a) shall not extend to United States evcess-profits taxes nor to the surtax imposed on personal holding companies.

7. Citizens of each of the contracting States residing within the other contracting State shall not be subjected in the latter State to other or higher taxes than are imposed upon the citizens of such latter State.

8. The provisions of this Convention shall not be construed to deny or affect in any manner the right of diplomatic and consular officers to other or additional exemptions now enjoyed or which may hereafter be granted to such officers, nor to deny to either of the contracting States the right to subject to taxation its own diplomatic and consular officers.

9. The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit or other allowance accorded by the laws of one of the contracting States in the determination of the tax imposed by such State.

10. In the administration of the provisions of this Convention relating to exchange of information, service of documents, and mutual assistance in collection of taxes, fees and costs incurred in the ordinary course shall be borne by the State to which application is made but extraordinary costs incident to special forms of procedure shall be borne by the applying State.

11. Documents and other communications or information contained therein, transmitted under the provisions of this Convention by one of the contracting States to the other contracting State shall not be published, revealed or disclosed to any person except to the extent permitted under the laws of the latter State with respect to similar documents, communications or information.

12. As used with respect to revenue claims in Article XVII of this Convention the term "finally determined" shall be deemed to mean:

(a) In the case of Sweden, claims which have been finally established, even though still open to revision by exceptional procedure;

(b) In the case of the United States of America, claims which are no longer appealable, or which have been determined by decision of a competent tribunal, which decision has become final.

13. As used in this Convention the term "competent authority" or "competent authorities" means, in the case of the United States of America, the Secretary of the Treasury and in the case of Sweden, the Finance Ministry.

14. The term "United States of America" as used in this Convention in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

15. Should any difficulty or doubt arise as to the interpretation or application of the present Convention, or its relationship to Conventions between one of the contracting States and any other State, the competent authorities of the contracting States may settle the question by mutual agreement.

16. The present Convention and Protocol shall not be deemed to affect the exchange of notes between the United States of America and Sweden providing relief from double income taxation on shipping profits, signed March 31, 1938.

Done at Washington, this twenty-third day of March, nineteen hundred and thirty-nine.

SUMNER WELLES [SEAL]
W. BOSTRÖM [SEAL]

And whereas the said convention and the said protocol have been duly ratified on both parts and the ratifications of the two Governments were exchanged at Stockholm on the fourteenth day of November, one thousand nine hundred and thirty-nine;

And whereas, as is provided in Article XXII, the said convention shall become effective on the first day of January following the exchange of the instruments of ratification;

Now, therefore, be it known that I, Franklin D. Roosevelt, President of the United States of America, have caused the said convention and the said protocol to be made public to the end that the same and every article, clause and part thereof may be observed and fulfilled with good faith by the United States of America and the citizens thereof on and from the first day of January, one thousand nine hundred and forty.

In testimony whereof, I have hereunder set my hand and caused the Seal of the United States of America to be affixed.

Done at the city of Washington this twelfth day of December, in the year of our Lord one thousand nine hundred and [SEAL] thirty-nine, and of the Independence of the United States of America the one hundred and sixty-fourth.

FRANKLIN D ROOSEVELT

By the President:
CORDELL HULL
Secretary of State.

(b) The Internal Revenue Code provides in part as follows:

SEC. 22. GROSS INCOME.

* * * * *

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

* * * * *

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

SEC. 62. RULES AND REGULATIONS.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this chapter.

§ 7.201 *Scope of this subpart.* (a) The primary purposes of the convention, to be accomplished on a mutually reciprocal basis, are the avoidance of double taxation, exchange of fiscal information complementary to those provisions of the convention relating to avoidance of double taxation, and mutual assistance in the collection of the taxes to which the convention relates. The regulations in this subpart deal primarily with the effect of the convention upon the determination of taxable income from sources within the United States of nonresident alien individuals resident in Sweden and of Swedish corporations and other Swedish entities, and with the information to be made available to the Finance Minister of Sweden.

(b) The specific classes of income from sources within the United States exempt

by reason of the convention from United States income tax are:

(1) Industrial and commercial profits of a Swedish enterprise having no permanent establishment in the United States (Article II);

(2) Income derived by a Swedish enterprise from the operation of ships or aircraft registered in Sweden (Article IV);

(3) Royalties and amounts derived by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity as consideration for the right to use copyrights, patents, secret processes and formulas, trade-marks and other analogous rights (Article VI);

(4) Gains derived from the sale or exchange of capital assets by a nonresident alien individual resident in Sweden, or by a Swedish corporation or other entity, having no permanent establishment in the United States (Article IX);

(5) Wages, salaries and similar compensation and pension paid by Sweden or by a political subdivision thereof to individuals (other than citizens of the United States) temporarily residing in the United States (Article X);

(6) Private pensions and life annuities paid to nonresident alien individuals residing in Sweden (Article X);

(7) Compensation for labor or personal services performed within the United States by a nonresident alien individual resident in Sweden, such exemption being, however, subject to the limitations set forth in Article XI of the convention and in § 7.212,

(8) Remittances from sources within Sweden (if and to the extent that they constitute gross income without regard to this convention) received in the United States by a nonresident alien individual resident of Sweden who is temporarily resident in the United States for the purposes of study or for acquiring business experience, such remittances being for the purposes of their maintenance or studies (Article XII).

(c) The convention does not affect the liability to United States income tax of Swedish citizens resident in the United States except to the extent such citizens are entitled to the benefits of Article XIV of the convention. For the purposes of the convention, an individual resident in neither Sweden nor the United States and claiming the benefits of the convention as a citizen of Sweden shall be deemed to be a resident of Sweden if it is shown to the satisfaction of the Commissioner that he is such citizen. With respect to dividends and interest, see § 7.209.

(d) Except as to those items of income expressly exempted by the convention, the income tax liability of a nonresident alien individual resident of Sweden and of a Swedish corporation or other entity is determined in accordance with the provisions of the internal revenue laws of the United States and the regulations thereunder applicable generally to the taxation of nonresident alien individuals and foreign corporations.

(e) Except insofar as concerns dividends, the convention makes no reference to rates of taxation imposed by the United States.

§ 7.202 *Definitions.* (a) Any word or term used in this subpart which is defined in the convention shall be given the definition assigned to such word or term in such convention. Any word or term used in this subpart which is not defined in the convention but is defined in the Internal Revenue Code shall be given the definition contained therein.

(b) As used in this subpart:

(1) The term "permanent establishment" includes branches, mines and oil wells, plantations, factories, workshops, warehouses, offices, agencies, installations and other fixed places of business of an enterprise but does not include the casual or temporary use of merely storage facilities. A Swedish parent corporation having a subsidiary corporation which latter corporation has a permanent establishment in the United States will not be deemed, by reason of such fact, to have itself a permanent establishment in the United States. A Swedish enterprise as defined in the convention carrying on business in the United States through an employee or agent, established in the United States, who has general authority to contract for his employer or principal, shall be deemed to have a permanent establishment in the United States. However, business dealings in the United States by a Swedish enterprise through a bona fide commission agent, broker or custodian do not constitute a permanent establishment in the United States.

(2) The term "enterprise" means any commercial or industrial undertaking whether conducted by an individual,

partnership, corporation or any other entity. It includes such activities as manufacturing, merchandising, mining, banking and insurance. It does not include the operation of, or the trading in, real property located in the United States. It does not include the rendition of personal services. Hence, a nonresident alien individual, a resident of Sweden, rendering personal services within the United States, is not merely by reason of such services, engaged in an enterprise within the meaning of the convention and his liability to Federal income tax is unaffected by Article II of the convention.

(3) The term "Swedish enterprise" means an enterprise carried on in Sweden by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity. The term "Swedish corporation or other entity" means a partnership, corporation or other entity created or organized in Sweden or under the laws of Sweden. For example, an enterprise carried on wholly without Sweden by a nonresident alien individual resident in Sweden is not a Swedish enterprise within the meaning of the convention.

(4) The term "industrial and commercial profits" means the profits arising from the industrial, mercantile, manufacturing or like undertakings of a Swedish enterprise as defined in this section. Such term does not include dividends, interest, compensation for labor or personal services, or income derived from real property or from any interest in such property, including rentals and royalties therefrom and gain from the sale or disposition thereof. Such latter items of income are not governed by the provisions of Article II but are subject to the rules elsewhere set forth in the convention and in this subpart with respect to such specific items of income. As to gains from the sale or exchange of capital assets, see § 7.210.

§ 7.203 *Scope of convention with respect to determination of "industrial and commercial profits" of a nonresident alien individual resident of Sweden or of a Swedish corporation or other entity carrying on a Swedish enterprise in the United States*—(a) *General.* Article II of the convention adopts the principle that an enterprise of one of the contracting States shall not be taxable in the other contracting State in respect of its industrial and commercial profits unless it has a permanent establishment in the latter State. Hence, a Swedish enterprise is subject to tax upon its industrial and commercial profits from sources within the United States only if it has a permanent establishment within the United States. From the standpoint of Federal income taxation, the article has application only to a Swedish enterprise and to the industrial and commercial income thereof from sources within the United States. It has no application, for example, to compensation for labor or personal services performed in the United States nor to income derived from real property located in the United States nor to any interest in such property, including rentals and royalties therefrom, nor to gains from the sale or disposition thereof nor to dividends and interest. Such latter items of income are treated separately elsewhere in the regulations in this subpart and are subject to the rules laid down in the sections having specific reference to the respective items of income: As to what is a "Swedish enterprise", a permanent establishment" and "industrial and commercial profits," see § 7.202.

(b) *No United States permanent establishment.* A nonresident alien individual resident in Sweden or a Swedish corporation or other entity, carrying on a Swedish enterprise but having no permanent establishment in the United States is not subject to United States income tax upon industrial and commercial profits from sources within the United States. For example, if such Swedish corporation sells stock in trade such as iron ore or wood pulp through a bona fide commission agent or broker in the United States, the resulting profit is, under the terms of Article II of the convention, exempt from United States income tax. Such Swedish corporation, however, remains subject to tax upon all other items of income from sources within the United States and not expressly exempted from such tax under the convention. However, see §§ 7.208, 7.210, 7.211 and 7.212.

(c) *United States permanent establishment.* A nonresident alien individual resident in Sweden or a Swedish corporation or other entity, carrying on a Swedish enterprise having a permanent establishment in the United States is subject to tax upon his or its industrial and commercial profits from

sources within the United States. In the determination of the income of such resident of Sweden or Swedish corporation or other entity from sources within the United States, all industrial and commercial profits from sources within the United States shall be deemed to be allocable to the permanent establishment within the United States. The net income from sources within the United States, including the industrial and commercial profits, shall be determined in accordance with the provisions of section 119, Internal Revenue Code, and regulations thereunder. In determining such income, no account shall be taken of the mere purchase of merchandise effected in the United States by such Swedish enterprise.

§ 7.204 *Control of a domestic enterprise by a Swedish enterprise.* Article III of the convention provides that if a Swedish enterprise by reason of its control of a domestic business imposes conditions different from those which would result from normal bargaining between independent enterprises, the accounts between the enterprises will be adjusted so as to ascertain the true net income of the domestic enterprises. The purpose is to place the controlled domestic enterprise on a tax parity with an uncontrolled domestic enterprise by determining, according to the standard of an uncontrolled enterprise, the true net income from the property and business of the controlled enterprise. The convention contemplates that if the accounting records do not truly reflect the net income from the property and business of such domestic enterprise the Commissioner shall intervene and, by making such distributions, apportionments or allocations as he may deem necessary of gross income or deductions or of any item or element affecting net income as between such domestic enterprise and the Swedish enterprise by which it is controlled or directed, determine the true net income of the domestic enterprise. The provisions of 26 CFR, 1938 ed., Supps., 19.45-1 (Regulations 103) shall, insofar as applicable, be followed in the determination of the net income of the domestic business.

§ 7.205 *Income from operation of ships or aircraft.* The income derived by a Swedish enterprise from the operation of ships or aircraft registered in Sweden is exempt from United States income tax. However, the profits derived by such enterprise from the operation of ships or aircraft not so registered are treated as are industrial and commercial profits generally. See Article II of the convention and § 7.203.

§ 7.206 *Income from real property.* Income of whatever nature derived by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity from real property situated in the United States, including gains derived from the sale of such property, is not exempt from taxation by the convention. The treatment of such income for taxation purposes is governed by those provisions of the Internal Revenue Code applicable generally to the taxation of nonresident aliens and foreign corporations. Interest derived from mortgages or bonds secured by real property does not constitute income from real property within the meaning of the convention but is subject to the provisions applicable to interest generally. See Article VIII of the convention and § 7.209.

§ 7.207 *Mineral royalties.* Royalties derived by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity from real property or in respect of the operation of mines, quarries, timber or other natural resources situated in the United States are not exempt from taxation under the convention. Such items of income are subject to taxation under the provisions of the Internal Revenue Code applicable generally to the taxation of nonresident aliens and foreign corporations.

§ 7.208 *Patent and copyright royalties.* (a) Royalties and amounts derived from sources within the United States by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity (if such corporation or entity is not a resident of the United States) as consideration for the right to use copyrights, patents, secret processes and formulas, trade-marks and other analogous rights are exempt from Federal income taxation under the provisions of Article VI of the convention. Such items are therefore not subject to the withholding provisions of the internal Revenue Code. Such exemption does not, however, apply in the case of a Swedish corporation engaged in trade or business within the United States or having an office or place of business therein. Such corporation is a resident Swedish

corporation and hence the provisions of Article XIV (a) are applicable.

(b) To obviate withholding of the tax at the source, the alien individual resident in Sweden or Swedish corporation or other entity should by letter, notify the payor of the income that such income is exempt from Federal income is exempt from Federal income taxation under the provisions of the convention. Such letter from such resident of Sweden shall contain his address and a statement that he is a resident of Sweden. The letter from such corporation or other entity shall contain the address of its office or place of business and a statement that it is a corporation or other entity organized under the laws of Sweden and shall be signed by an officer of the corporation or other entity giving his official title. The letter of notification of a copy thereof should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Withholding Returns Section, Washington 25, D. C., United States of America.

§ 7.209 *Dividends and interest.* (a) In general dividends derived from sources within the United States by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity remain subject to taxation under the provisions of the Internal Revenu Code applicable generally to the taxation of nonresident alien individuals and foreign corporations. See Article XIV (a) of the convention. However, for a period of at least 2 years beginning on January 1, 1940, the tax in the case of such alien individual resident in Sweden or such Swedish corporation or other entity (nonresident as to the United States) shall not exceed 10 percent of the amount of such dividends. See Article VII of the convention. Hence, the higher rates applicable generally in the case of nonresident alien individuals subject to the provisions of section 211 (c), Internal Revenue Code, are not applicable to dividends received by nonresident alien individuals who are residents of Sweden.

(b) The taxation of interest derived from sources within the United States by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity is not affected by the convention except that in the case of such individual such interest is subject only to the rate of tax imposed by section 211 (a), Internal Revenue Code. Hence, interest, like dividends, is excluded for the purposes of section 211 (c), from the gross amount of fixed or determinable annual or periodical income of nonresident alien individuals who are residents of Sweden.

§ 7.210 *Capital gains.* Under Article IX of the convention, gain derived from the sale or exchange of capital assets (other than real property) within the United States by a nonresident alien individual resident in Sweden or by a Swedish corporation or other entity is exempt from Federal income tax unless such individual, corporation or other entity has a permanent establishment in the United States. With respect to real property, see § 7.206.

§ 7.211 *Wages, salaries and similar compensation, pensions and life annuities.* (a) Under Article X of the convention wages, salaries and similar compensation and pensions paid by Sweden or by a political subdivision thereof to individuals temporarily residing in the United States are exempt from Federal income tax. By reason, however, of the application of Article XIV (a) of the convention, such exemption does not apply to recipients of such income who are either citizens of the United States or aliens resident therein. As to who are resident aliens, see 26 CFR, 1938 ed., Supps., 19.211-2 to 19.2111-4 (Regulations 103). As to the taxation generally of the compensation of employees of foreign governments, see section 116 (h) of the Internal Revenue Code and 26 CFR, 1938 ed., Supps., 19.116-1 (Regulations 103).

(b) Under the provisions of the same article of the convention, private pensions and life annuities derived from sources within the United States by nonresident alien individuals residing in Sweden are exempt from the Federal income tax. Such items of income are, therefore, not subject to the withholding provisions of the Internal Revenue Code. See paragraph 5 of the protocol to the convention as to what constitutes life annuities. See also § 7.208 with respect to patent and copyright royalties as to requirements necessary to avoid withholding of the tax at the source, which requirements are here also applicable.

§ 7.212 *Compensation for labor or personal services.* (a) Article XI of the convention adopts the principle that compensation for labor or personal serv-

ices, including compensation realized in the practice of the liberal professions, is subject to tax only in the contracting State in which such services are rendered. Hence, in general such compensation derived by nonresident alien individuals residing in Sweden for services rendered in the United States is subject to Federal income tax. Such general rule is, however, subject to the following exceptions under the provisions of Article XI:

(1) Such nonresident alien individual is not subject to Federal income tax upon compensation for labor or personal services performed within the United States if the following conditions prescribed by subparagraph (2) (i) and (ii) of this paragraph are met:

(2) He is temporarily present in the United States for a period or periods:

(i) Not exceeding 180 days during the taxable year and his compensation is received for labor or personal services performed as an employee of, or under contract with, a resident of Sweden or a Swedish corporation or other entity; or

(ii) Not exceeding 90 days during the taxable year and the compensation received for such services does not exceed $3,000 in the aggregate for such taxable year even though such compensation is paid by a United States resident or by a domestic corporation or other domestic entity.

(b) If, therefore, such nonresident alien individual (1) is temporarily present in the United States for a period or periods in excess of 90 days during the taxable year, or (2) receives more than $3,000 in the aggregate during the taxable year for labor or personal services performed within the United States he is not exempt under paragraph (a) (2) (ii) of this section, and his right to exemption under the convention will depend on his meeting both tests prescribed under paragraph (a) (2) (i) of this section.

(c) These exceptions, however, do not extend to the professional earnings of actors, artists, musicians, professional athletes and those engaged in like activities. The professional earnings of such individuals resident in Sweden for services rendered within the United States are subject to the provisions of the Internal Revenue Code applicable generally to the taxation of nonresident alien individuals.

§ 7.213 *Remittances.* Under Article XII nonresident alien individuals residents of Sweden who are temporarily residing in the United States exclusively for the purposes of study or acquiring business experience and receiving remittances from Sweden for the purposes of their maintenance and studies in the United States are exempt from Federal income tax upon such amounts if and to the extent that such amounts constitute gross income.

§ 7.214 *Scope of Article XIV*—(a) *General.* Article XIV (a) has an important bearing upon other articles of the convention. While many preceding articles provide in effect that items of income derived by citizens or residents of the United States or by domestic corporations from sources in Sweden are subject to tax only in Sweden, Article XIV (a) nevertheless permits the imposition of Federal income tax upon such income in the hands of such taxpayers. For example, Article V provides that income from real property, including gains derived from the sale or exchange of such property, shall be taxable only in the contracting State in which such property is situated. Hence, looking at such article without reference to Article XIV a United States citizen realizing such income from real property situated within Sweden would not be subject to Federal income tax upon such income. Article XIV (a), however, prescribes that, notwithstanding Article V or any other article of the convention, the Federal income tax may apply to all items of income without regard to other provisions of the convention and hence all items of income from sources within Sweden, regardless of their treatment in the articles dealing respectively with such items of income, must be included in gross income of United States citizens, residents and corporations for the purposes of the Federal income tax.

(b) *Credit for Swedish income taxes.* (1) Article XIV (a), for the purposes of avoidance of double taxation, further provides that a citizen or resident of the United States or a domestic corporation deriving income from sources within Sweden shall be entitled to a credit against the Federal income tax liability for the amount of Swedish national income and property tax, including surtax, and for the Swedish communal income tax. Such credit is, however, subject to the limitations prescribed in section 131,

Internal Revenue Code (relating to the credit for foreign taxes) in that it cannot exceed the same proportion of the tax against which the credit is taken which the taxpayer's net income from sources within Sweden bears to the entire net income, in the case of a taxpayer other than a corporation, or to the normal tax net income, in the case of a corporation, for the same taxable year.

(2) In the application of Article XIV (a), the provisions of section 131, Internal Revenue Code, are in general applicable. See paragraph 6 of the protocol to the convention.

§ 7.215 *Reciprocal administrative assistance.* (a) By Article XV of the convention, United States and Sweden adopt the principle of exchange of information and assistance in the service of documents incident to the collection of taxes. It is agreed that such fiscal cooperation shall be carried out in accordance with the laws of the respective countries and hence only such information as is available to the Commissioner under the revenue laws may be used as a source from which to secure the information required to be submitted to the Finance Minister of Sweden.

(b) Pursuant to such principle, withholding agents shall, in the preparation of withholding returns, Form 1042, report on such returns, in addition to the items of income upon which tax has been withheld at the source, those items of income paid to a nonresident alien individual resident in Sweden or to a Swedish corporation or other entity upon which tax has not been withheld at the source. (See § 7.208.) Such return shall show the same information with respect to such items of income upon which tax has not been withheld at the source as is shown with respect to items of income upon which the tax has been withheld as the source.

(c) All information and correspondence relating to exchange of information and to service of documents may be transmitted by the Secretary directly to the Finance Minister of Sweden.

§ 7.216 *Information to be furnished in the ordinary course.* (a) In accordance with the provisions of Article XVI (1) (a) and (b) of the convention, the Secretary shall forward to the Finance Minister of Sweden, Stockholm, Sweden, as soon as practicable after the close of the calendar year 1940 and of each calendar year thereafter during which the convention is in effect the following information relating to such preceding calendar year:

(1) The name and address of each person whose address as disclosed on Forms 1012 and 1042 is in Sweden deriving from sources within the United States dividends, interest, royalties, pensions, annuities, or other fixed or determinable annual or periodical income, showing the amount of such income with respect to such person.

(2) The name and address of each person whose address as disclosed by Forms 1000, 1087 and 1099 is in Sweden showing the amount of income set forth on such form with respect to each person.

(b) In accordance with the provisions of Article XVI (1) (c) of the convention, there shall likewise be forwarded any particulars which the Commissioner may obtain incident to the determination of estate tax liability of any decedent from inventories of assets of estates of decedents concerning debts contracted with individuals resident in Sweden or with Swedish corporations or other entities.

§ 7.217 *Information in specific cases.* Under the provisions of Article XVIII of the convention and upon request of the Finance Minister of Sweden, made through diplomatic channels and subject to the provisions of Article XIX of the convention, the Secretary will furnish to the Finance Minister of Sweden particulars in case of any specific taxpayer who is a citizen of Sweden or a Swedish corporation or other entity, relating to the application of Swedish national income and property tax and the Swedish communal income tax. In the case of other specific taxpayers, the Secretary will give consideration to requests of the Finance Minister of Sweden with a view to furnishing similar information concerning such taxpayer.

§ 7.218 *Mutual assistance in the collection of taxes.* Under the provisions of Article XXI of the convention, the Secretary of the Treasury and the Finance Minister of Sweden are authorized to prescribe rules with respect to those provisions of the convention relating to the exchange of information, service of documents, and mutual assistance in the collection of the taxes to which the convention relates. Such rules concerning matters of procedure, forms of application and replies thereto, conversion of

currency, disposition of amounts collected and related matters will be made the subject matter of a common agreement between the competent authorities of the two contracting States concerned and when consummated will be published.

SUBPART—FRANCE

REGULATIONS EFFECTIVE JAN. 1, 1945

AUTHORITY: §§ 7.410 to 7.426 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 7.410 to 7.426 contained in Treasury Decision 5499, 11 F. R. 2154.

§ 7.410 *Introductory.* The tax convention and protocol between the United States and France (referred to in this subpart as the convention) proclaimed by the President of the United States on January 5, 1945, and effective January 1, 1945, provide in part as follows:

TITLE I—DOUBLE TAXATION

ARTICLE 1

The taxes referred to in this Convention are:

(a) In the case of the United States of America: The federal income taxes, including surtaxes and excess-profits taxes;

(b) In the case of France:

(1) The real estate tax;

(2) The industrial and commercial profits tax;

(3) The annual tax on undistributed profits;

(4) The agricultural profits tax;

(5) The tax on salaries, allowances and emoluments, wages, pensions and annuities;

(6) The professional profits tax;

(7) The tax on income from securities and movable capital;

(8) The general income tax.

ARTICLE 2

Income from real property, including income from agricultural undertakings, shall be taxable only in the State in which such real property is situated.

ARTICLE 3

An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in the latter State.

No account shall be taken, in determining the tax in one of the contracting States, of the purchase of merchandise effected therein by an enterprise of the other State for the purpose of supplying establishments maintained by such enterprise in the latter State.

The competent authorities of the two contracting States may lay down rules by agreement for the apportionment of industrial and commercial profits.

The term "industrial and commercial profits" shall not include the following:

(a) Income from real property;

(b) Income from mortgages, from public funds, securities (including mortgage bonds), loans, deposits and current accounts;

(c) Dividends and other income from shares in a corporation;

(d) Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulae, good-will, trade marks, trade brands, franchises and other like property;

(e) Profit or loss from the sale or exchange of capital assets.

Subject to the provisions of this Convention the income referred to in paragraphs (a), (b), (c), (d) and (e) shall be taxed separately or together with industrial and commercial profits in accordance with the laws of the contracting States.

ARTICLE 4

American enterprises having permanent establishments in France are required to submit to the French fiscal administration the same declarations and the same justifications, with respect to such establishments, as French enterprises.

The French fiscal administration has the right, within the provisions of its national legislation and subject to the measures of appeal provided in such legislation, to make such corrections in the declaration of profits realized in France as may be necessary to show the exact amount of such profits.

The same principle applies mutatis mutandis to French enterprises having permanent establishments in the United States.

ARTICLE 5

When an American enterprise, by reason of its participation in the management or capital of a French enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with a third enterprise, any profits which should normally have appeared in the balance sheet of the French enterprise, but which have been in this manner, diverted to the American enterprise, are, subject to the measures of appeal applicable in the case of the tax on industrial and commercial profits, incorporated in the taxable profits of the French enterprise.

The same principle applies mutatis mutandis, in the event that profits arc diverted from an American enterprise to a French enterprise.

ARTICLE 6

Income derived by navigation enterprises of one of the contracting States from the operation of ships documented under the laws of that State shall continue to benefit

in the other State by the reciprocal tax exemptions accorded by the exchange of notes of June 11 and July 8, 1927 between the United States of America and France.

Income which an enterprise of one of the contracting States derives from the operation of aircraft registered in that State shall be exempt from taxation in the other State.

ARTICLE 7

Royalties from real property or in respect of the operation of mines, quarries or other natural resources shall be taxable only in the contracting State in which such property, mines, quarries or other natural resources are situated.

Royalties derived from within one of the contracting States by a resident or by a corporation or other entity of the other contracting State as consideration for the right to use copyrights, patents, secret processes and formulae, trademarks and other analogous rights shall be exempt from taxation in the former State, provided such resident, corporation or other entity does not have a permanent establishment there.

ARTICLE 8

Wages, salaries and similar compensation and pensions paid by one of the contracting States or by a political subdivision thereof to individuals residing in the other State shall be exempt from taxation in the latter State.

Private pensions and life annuities derived from within one of the contracting States and paid to individuals residing in the other contracting State shall be exempt from taxation in the former State.

ARTICLE 9

Income from labor or personal services shall be taxable only in the State in which the taxpayer carries on his personal activity.

This provision does not apply to the income referred to in Article 8.

ARTICLE 10

Income from the exercise of a liberal profession shall be taxable only in the State in which the professional activity is exercised.

There is the exercise of a liberal profession in one of the two contracting States only when the professional activity has a fixed center in that country.

ARTICLE 11

Gains derived in one of the contracting States from the sale or exchange of stocks, securities or commodities by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

ARTICLE 12

Students from one of the contracting States residing in the other contracting State exclusively for the purpose of study shall not be taxable by the latter State in respect of remittances received from within the former State for the purpose of their maintenance or studies.

ARTICLE 13

In the calculation of taxes established in one of the contracting States on the use of property or increment of property of an enterprise of the other State, account shall be taken only of that portion of the capital situated or employed and allocable to a permanent establishment within the former State.

The foregoing provision shall apply to the French "patent" tax and the United States capital stock tax even though these two taxes have not been referred to in Article 1 of the present Convention.

In the application of the present Article navigation enterprises of one of the contracting States, enjoying in the other State the benefits of Article 6 of the present Convention, shall not be considered as having a permanent establishment in the latter State insofar as shipping activities are concerned.

ARTICLE 14

It is agreed that double taxation shall be avoided in the following manner:

A. *As regards the United States of America.* Notwithstanding any other provision of this Convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens, or residents, or corporations, may include in the basis upon which such taxes are imposed, all items of income taxable under the Revenue Laws of the United States of America, as though this Convention had not come into effect. The United States of America shall, however, deduct from the taxes thus computed the amount of French income tax paid. This deduction shall be made in accordance with the benefits and limitations of Section 131 of the United States Internal Revenue Code relating to credit for foreign taxes.

B. *As regards France*—(a) *Schedular taxes.* Income from securities, debts and trusts having its source in the United States of America shall be subject in France to the tax on income from securities; but this tax shall be reduced by the amount of the tax already paid in the United States of America on the same income. In consideration of the fiscal regime to which the legislation of the United States of America subjects the income of nonresident aliens and foreign corporations or other entities, the deduction of the tax paid in the United States of America shall be effected in a lump sum through a reduction of 12 in the rate of the tax established by the French law.

The income other than that indicated in the preceding paragraph shall not be subject to any schedular tax in France when, according to this Convention, it is taxable in the United States of America.

(b) *General tax on revenue.* Notwithstanding any other provision of the present Convention, the general income tax can be determined according to all the elements of taxable income as imposed by French fiscal legislation.

However, the provisions of the first paragraph of Article 114 of the French Code on direct taxation relative to the taxation of aliens domiciled or resident in France shall continue to be applied.

ARTICLE 15

In derogation of Article 3 of the Decree of December 6, 1872, American corporations which maintain in France permanent establishments shall be liable to the tax on income from securities on three-fourths of the profits actually derived from such establishments, the industrial and commercial profits being determined in accordance with Articles 3 and 4 of this Convention.

The remaining one-fourth shall, in all cases, be taken as the basis of the annual tax on undistributed profits applicable to the same corporations.

ARTICLE 16

An American corporation shall not be subject to the obligations prescribed by Article 3 of the Decree of December 6, 1872, by reason of any participation in the management or in the capital of, or any other relations with, a French corporation. In such case, the tax on income from securities continues to be levied, in conformity with French legislation, on the dividends, interest and all other distributions made by the French enterprise; but it is moreover collectible, if the occasion arises, and subject to the measures of appeal applicable in the case of the tax on income from securities, with respect to the profits which the American corporation derives from the French corporation under the conditions prescribed in Article 5.

ARTICLE 17

The American corporations subject to the provisions of Article 3 of the Decree of December 6, 1872 who were not placed under the special regime established by Articles 5 and 6 of the Convention for the avoidance of double income taxation between the United States of America and France, signed April 27, 1932, may, during a new period of six months from the date of the entry into force of the present Convention, exercise with reference to past years, the option provided in those two articles under the conditions which they prescribe.

Moreover, the American corporations contemplated in the third paragraph of Article 10 of the Convention of April 27, 1932, may be admitted to benefit from the provisions of that paragraph, when the tax has not yet been paid, if the latter was not found to be payable, prior to May 1, 1930, by a definitive judicial decision or if such decision has been the subject of an appeal in cassation.

ARTICLE 18

Any United States income tax liability remaining unpaid as at the effective date of this Convention for years beginning prior to January 1, 1936 of any individual resident of France (other than a citizen of the United States of America) or of a French corporation may be adjusted by the Commissioner of Internal Revenue of the United States of America, on the basis of the provisions of the United States Revenue Act of 1936. However, no adjustment will be made more than two years subsequent to the effective date of this Convention unless the taxpayer files a request with the Commissioner of Internal Revenue prior to such date.

ARTICLE 19

Notwithstanding any other provision of this Convention, in order to avoid double taxation on public servants, employees of one of the contracting States being citizens of that State and remunerated by it, who have been received by the other State to perform services in such State shall be exempt in their principal place of residence from direct and personal taxes whether national, state or local.

Such employees who own real property in the State in which they perform services shall not benefit from the above exemptions with respect to the taxes levied on such real property. Employees who engage in any private gainful occupation in such State shall not be entitled to any exemption under this Article.

TITLE II—FISCAL ASSISTANCE

ARTICLE 20

With a view to the more effective imposition of the taxes to which the present Convention relates, the contracting States undertake, on condition of reciprocity, to furnish information of a fiscal nature which the authorities of each State concerned have at their disposal, or are in a position to obtain under their own laws, that may be of use to the authorities of the other State in the assessment of the said taxes.

Such information shall be exchanged between the competent authorities of the contracting States in the ordinary course or on request.

ARTICLE 21

In accordance with the preceding Article, the competent authorities of the United States of America will transmit to the competent authorities of France, as regards any person, corporation or other entity (other than a citizen, corporation or other entity of the United States of America) having an address in France and deriving from sources within the United States of America rents, dividends, interest, royalties, income from trusts, wages, salaries, pensions, annuities, or other fixed or determinable periodical income, the name and address of such person, corporation or other entity as well as the amount of such income.

The competent authorities of France will transmit to the competent authorities of the United States of America, as regards any person, corporation or other entity (other than a citizen, corporation or other entity of France) having an address in the United States of America and deriving from sources within France rents, dividends, interest, royalties, income from trusts, wages, salaries, pensions, annuities, or other fixed or determinable periodical income, the name and address of such person, corporation or other entity as well as the amount of such income.

The information relating to each year will be transmitted as soon as possible after December 31.

ARTICLE 22

The competent authorities of each of the contracting States shall be entitled to obtain, through diplomatic channels, from the competent authorities of the other contracting State, except with respect to citizens, corporations or other entities of the State to which application is made, particulars in concrete cases necessary for the establishment of the taxes to which the present Convention relates.

However, the competent authorities of each State shall not be prevented from transmitting to the competent authorities of the other State information relating to their own nationals (citizens, corporations or other entities) if they deem it opportune for the prevention of fiscal evasion.

ARTICLE 23

Each contracting State undertakes to lend assistance and support in the collection of the taxes to which the present Convention relates, together with interest, costs, and additions to the taxes and fines not being of a penal character according to the laws of the State requested, in the cases where the taxes are definitively due according to the laws of the State making the application.

In the case of an application for enforcement of taxes, revenue claims of each of the contracting States which have been finally determined shall be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

The application shall be accompanied by such documents as are required by the laws of the State making the application, to establish that the taxes have been finally determined.

If the revenue claim has not been finally determined, the State to which application is made may, at the request of the State making the application, take such measures of conservancy as are authorized by the laws of the former State for the enforcement of its own taxes.

The assistance provided for in this Article shall not be accorded with respect to the citizens, corporations or other entities of the State to which application is made.

ARTICLE 24

In no case shall the provisions of Article 22 relating to particulars in concrete cases, or of Article 23 relating to mutual assistance in the collection of taxes, be construed so as to impose upon either of the contracting States the obligation to carry out administrative measures at variance with the regulations and practice of either contracting State, or to supply particulars which are not procurable under the law of the State to which application is made, or that of the State making application.

The State to which application is made for information or assistance shall comply as soon as possible with the request addressed to it. Nevertheless, such State may refuse to comply with the request for reasons of public policy or if compliance would involve violation of a business, industrial or trade secret. In such case it shall inform, as soon as possible, the State making the application.

ARTICLE 25

Any taxpayer who shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present Convention relates, shall be entitled to lodge a claim with the State of which he is a citizen or, if the taxpayer is a corporation or other entity, with the State in which it is created or organized. Should the claim be upheld, the competent authority of such State may come to an agreement with the competent authority of the other State with a view to equitable avoidance of the double taxation in question.

ARTICLE 26

The competent authorities of the two contracting States may prescribe regulations necessary to interpret and carry out the provisions of this Convention. With respect to the provisions of this Convention relating to exchange of information and mutual assistance in the collection of taxes, such authorities may, by common agreement, prescribe rules concerning matters of procedure, forms of application and replies thereto, rates of conversion of currencies, transfer of sums collected, minimum amounts subject to collection, payment of costs of collection, and related matters.

TITLE III—GENERAL PROVISIONS

ARTICLE 27

The present Convention shall be ratified, in the case of the United States of America by the President, by and with the advice and consent of the Senate, and in the case of France, by the President of the French Republic with the consent of the Parliament.

This Convention shall become effective on the first day of January following the exchange of the instruments of ratification.

The Convention shall remain in force for a period of five years and indefinitely there-

after but may be terminated by either contracting State at the end of the five-year period or at any time thereafter, provided six months' prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

Upon the coming into effect of this Convention, the Convention for the avoidance of double income taxation between the United States of America and France, signed April 27, 1932 shall terminate.

Done at Paris, in duplicate, in the English and French languages, this 25th day of July, 1939.

[SEAL] WILLIAM C. BULLITT
[SEAL] GEORGES BONNET

PROTOCOL

At the moment of signing the present Convention for the avoidance of double taxation and the establishment of rules of reciprocal administrative assistance in the case of income and other taxes, the undersigned Plenipotentiaries have agreed that the following provisions shall form an integral part of the Convention:

I. The present Convention is concluded with reference to American and French law in force on the day of its signature.

Accordingly, if these laws are appreciably modified the competent authorities of the two States will consult together.

II. The income from real property referred to in Article 2 of the present Convention shall include profits from the sale or exchange of the said property, but shall not include interest on mortgages or obligations secured by the said property.

III. As used in this Convention:

(a) The term "permanent establishment" includes branches, mines and oil wells, plantations, factories, workshops, stores, purchasing and selling and other offices, agencies, warehouses, and other fixed places of business but does not include a subsidiary corporation.

When an enterprise of one of the contracting States carries on business in the other State through an employee or agent, established there, who has general authority to negotiate and conclude contracts or has a stock of merchandise from which he regularly fills orders which he receives, this enterprise shall be deemed to have a permanent establishment in the latter State. But the fact that an enterprise of one of the contracting States has business dealings in the other State through a bona fide commission agent or broker shall not be held to mean that such enterprise has a permanent establishment in the latter State.

Insurance enterprises shall be considered as having a permanent establishment in one of the States as soon as they receive premiums from or insure risks in the territory of that State.

(b) The term "enterprise" includes every form of undertaking whether carried on by an individual, partnership, corporation, or any other entity.

(c) The term "enterprise of one of the contracting States" means, as the case may be, "United States enterprise" or "French enterprise".

(d) The term "United States enterprise" means an enterprise carried on in the United States of America by a resident of the United States of America or by a United States corporation or other entity.

The term "United States corporation or other entity" means a partnership, corporation or other entity created or organized in the United States of America or under the law of the United States of America or of any State or Territory of the United States of America.

(e) The term "French enterprise" is defined in the same manner, mutatis mutandis, as the term "United States enterprise".

IV. The term "life annuities" referred to in Article 8 of this Convention means a stated sum payable periodically at stated times during life, or during a specified number of years to the person who has paid the premiums or a gross sum for such an obligation.

V. Citizens and corporations or other entities of one of the contracting States within the other contracting State shall not be subjected as regards the taxes referred to in the present Convention, to the payment of higher taxes than are imposed upon the citizens or corporations or other entities of such latter State.

VI. The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit, allowance, or other advantage accorded by the laws of one of the contracting States in the determination of the tax imposed by such State.

VII. Documents and information contained therein, transmitted under the provisions of this Convention by one of the contracting States to the other contracting State shall not be published, revealed or disclosed to any person except to the extent permitted under the laws of the latter State with respect to similar documents or information.

VIII. As used in this Convention the terms "competent authority" or "competent authorities" means, in the case of the United States of America, the Secretary of the Treasury and in the case of France, the Minister of Finance.

IX. The term "United States of America" as used in this Convention in a geographic sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

X. The term "France", when used in a geographic sense, indicates continental France, exclusive of Algeria and the Colonies.

XI. Should any difficulty or doubt arise as to the interpretation or application of the present Convention, or its relationship to Conventions between one of the contracting States and any other State, the competent authorities of the contracting States may settle the question by mutual agreement.

Done in duplicate at Paris, this 25th day of July, 1939.

WILLIAM C. BULLITT
GEORGES BONNET

§ 7.411 *Applicable provisions of the Internal Revenue Code.* (a) The Internal Revenue Code provides in part as follows:

SEC. 22. GROSS INCOME. * * *

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

* * * * *

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

* * * * *

SEC. 62. RULES AND REGULATIONS.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this chapter.

(b) Pursuant to section 62 of the Internal Revenue Code, Article 26 of the convention, and other provisions of the internal revenue laws, §§ 7.412–7.426 are hereby prescribed and all regulations inconsistent herewith are modified accordingly.

§ 7.412 *Scope of the convention.* (a) The primary purposes of the convention are to avoid double taxation upon certain classes of income, and to inaugurate fiscal cooperation between the two States with respect to reciprocal disclosure of information and to the collection of the taxes enumerated in Article 1 of the convention.

(b) The specific classes of income from sources within the United States exempt under the convention from United States income taxes are:

(1) Industrial and commercial profits of a French enterprise having no permanent establishment in the United States (Article 3);

(2) Income derived by a French enterprise from the operation of ships documented under the laws of, or aircraft registered in, France (Article 6);

(3) Royalties derived by a nonresident alien who is a resident of France or by a French corporation or other French entity (having no permanent establishment within the United States), for the right to use copyrights, patents, secret processes and formulae, trademarks and other analogous rights (Article 7);

(4) Compensation and pensions paid by France or by a political subdivision of France to individuals (other than citizens of the United States) for services rendered to France whether within or without the United States (Article 8);

(5) Private pensions and life annuities derived from within the United States and paid to nonresident alien individuals (whether or not such individuals are citizens of France) residing in France during the year in which such amounts are paid (Article 8);

(6) Earned income of a doctor, lawyer, engineer, or other member of a liberal profession who is a nonresident alien individual and is a resident of France and does not maintain within the United States an office, establishment, installation, or other fixed center related to the practice of his profession within the United States (Article 10);

(7) Gains from sources within the United States arising from the sale or exchange of stocks, securities, or commodities by a resident of France (other than a citizen of the United States) or a French corporation or other French entity unless such resident, corporation, or other entity has, at any time during the taxable year in which such sale takes place, a permanent establishment within the United States (Article 11).

(c) Except as expressly provided by the convention, the tax liability of nonresident aliens who are residents of France or of French corporations or other French entities is determined in accordance with the provisions of the laws and of the regulations thereunder applicable generally to nonresident alien individuals and to foreign corporations.

(d) The convention shall not be construed to affect the liability to United States income taxation of citizens of France who are resident in the United States except to the extent that such individuals are entitled to the benefits of Articles 8, 14 A, and 19 and to paragraph V of the protocol of the convention. The tax liability of a United States citizen or a resident of the United States, a member of a French partnership carrying on a French enterprise is not affected by Article 3 of the convention. Such citizen or resident is subject to United States income tax upon his distributive share of the net income of such partnership even though the other members of such partnership are not subject to tax upon

their share of the partnership's industrial and commercial profits from sources within the United States where the enterprise has no permanent establishment within the United States. The convention shall not be construed to affect the liability to United States income taxation of citizens of the United States or residents of the United States who are not citizens of France.

(e) The convention has no reference to rates of taxation imposed by the respective States but is concerned with the exempting of income arising in one of the contracting States when such income is derived from sources within such contracting State by a resident or corporation or other entity of the other contracting State and meets the conditions upon which such exemption depends as prescribed in the convention. This subpart is not concerned with the provisions of Articles 14B, 15, 16, and 17 of the convention since such articles affect only the allowance against the taxes imposed by France of income and excess profits taxes paid to the United States or the application of French revenue laws and decrees.

§ 7.413 *Definitions.* (a) Any word or term used in this subpart which is defined in the convention shall be given the definition assigned to such word or term in such convention. Any word or term used in this subpart which is not defined in the convention but is defined in the Internal Revenue Code shall be given the definition contained therein.

(b) As used in this subpart:

(1) The term "permanent establishment" includes branches, mines and oil wells, plantations, factories, workshops, stores, purchasing and selling and other offices, agencies, warehouses and other fixed places of business. A French parent corporation having a domestic or foreign subsidiary corporation in the United States shall not be deemed by reason of such fact to have a permanent establishment in the United States. The mere fact that a foreign subsidiary corporation of a French parent corporation has a permanent establishment in the United States does not mean that such French parent corporation has a permanent establishment in the United States. The fact that a French enterprise carries on business dealings in the United States through a bona fide commission agent or broker shall not be held to mean that such enterprise has a permanent establishment in the United States. If, however, a French enterprise carries on business in the United States through an employee or agent established there who has general authority to negotiate and conclude contracts or has a stock of merchandise from which he regularly fills orders, such enterprise shall be deemed to have a permanent establishment in the United States. Thus, if a French enterprise has a full time employee or full time agent who for such enterprise maintains in the United States a stock of merchandise from which orders are filled, such enterprise has a permanent establishment in the United States even though such employee or agent has no general authority to negotiate and conclude contracts on behalf of such enterprise. However, the mere fact that a commission agent or broker through whom a French enterprise carries on business in the United States maintains a small stock of goods in the United States from which occasional orders are filled shall not be construed as meaning that such enterprise has a permanent establishment in the United States. The mere fact that salesmen, employees of a French enterprise, promote the sale of its products in the United States does not mean that such enterprise has a permanent establishment therein. However, a French insurance enterprise which insures risks within the United States or receives premiums from sources within the United States is deemed to have a permanent establishment within the United States.

(2) The term "enterprise" means any commercial or industrial undertaking, whether conducted by an individual, partnership, corporation, or other entity. It includes such activities as manufacturing, merchandising, mining, banking, and insurance. It does not include the operation of, or the trading in, real property located in the United States. It does not include the rendition of personal services. Hence, a nonresident alien individual who is a resident of France, rendering personal services within the United States is not, merely by reason of such services, engaged in an enterprise within the meaning of the convention, and his liability to United States income tax is unaffected by Article 3 of the Convention.

(3) The term "French enterprise" means an enterprise carried on in France

by a nonresident alien individual resident of France or by a French corporation or other French entity. The term "corporation or other entity" means a partnership, corporation, or other entity created or organized in France or under the laws of France. For example, an enterprise carried on wholly outside France by a French corporation is not a French enterprise within the meaning of the convention. Whether a French entity is a corporation, a partnership, or a trust is to be determined in accordance with the principles of existing law relating to the taxation of nonresident aliens and foreign corporations.

(4) The term "industrial and commercial profits" means the profits arising from the industrial, mercantile, manufacturing, or like activities of a French enterprise as defined in this section. Such term does not include income from real property, interest, dividends, rentals and royalties, gains from the sale or exchange of capital assets, or compensation for labor or personal services. Such enumerated items of income are not governed by the provisions of Article 3 but, to the extent covered by the convention, are subject to the rules elsewhere set forth therein and in this subpart.

(5) The term "Secretary" means the Secretary of the Treasury and the term "Minister" means the Minister of Finance of France.

§ 7.414 *Scope of convention with respect to determination of "industrial and commercial profits" of a nonresident alien individual resident of France, or of a French corporation or other entity carrying on a French cnterprise in the United States*—(a) *General.* Article 3 of the convention adopts the principle that an enterprise of one of the contracting States shall not be taxable in the other contracting State in respect of its industrial and commercial profits unless it has a permanent establishment in the latter State. Hence, a French enterprise is subject to United States tax upon its industrial and commercial profits from sources within the United States only if it has a permanent establishment within the United States. From the standpoint of Federal income taxation, the article has application only to a French enterprise and to the industrial and commercial income thereof from sources within the United States. It has no application, for example, to compensation for labor or personal services performed in the United States, to income derived from real property located in the United States or any interest therein, including rentals and royalties, to gains from the sale or other disposition of such real property or interest, to dividends and interest, to rentals and royalties arising from leasing personal property or any interest in such property, including rentals and royalities for the use of patents, copyrights, secret processes and formulae, good will, trade marks, trade brands, franchises, and other like property, or to profits from the sale or exchange of capital assets. Such enumerated items of income, to the extent covered by the convention, are treated separately elsewhere in this subpart and are subject to the rules laid down in the sections having specific reference to the respective items of income.

(b) *No United States permanent establishment.* A nonresident alien individual who is a resident of France, or a French corporation or other French entity carrying on a French enterprise, but having no permanent establishment in the United States, is not subject to United States income tax upon industrial and commercial profits from sources within the United States. For example, if such French corporation sells stock in trade, such as wines or prefumery or cheese, through a bona fide commission agent or broker in the United States, the resulting profit is, under the terms of Article 3 of the convention, exempt from United States income tax. Such French corporation, however, remains subject to tax upon all other items of income from sources within the United States which are not expressly exempted from such tax under the convention.

(c) *United States permanent establishment.* A nonresident alien individual who is a resident of France, or a French corporation or other entity, carrying on a French enterprise having a permanent establishment in the United States is subject to tax upon his or its industrial and commercial profits from sources within the United States. In the determination of the income of such resident of France or French corporation or other entity from sources within the United States, all industrial and commercial profits from such sources shall be deemed to be allocable to the permanent establishment within the United States. Hence, for example, if a French enterprise, having a permanent establishment

in the United States, sells directly in the United States through a commission agent or broker therein goods produced in France, the resulting profits derived from United States sources from the latter transactions are allocable to such permanent establishment. The net income from sources within the United States, including the industrial and commercial profits, shall be determined in accordance with the provisions of section 119 of the Internal Revenue Code and the regulations thereunder. In determining industrial and commercial profits no account shall be taken of the mere purchase of merchandise effected in the United States by such French enterprise. A nonresident alien who is a resident of France, a member of a French partnership having a permanent establishment within the United States, shall by reason of such fact be deemed to have a permanent establishment within the United States.

§ 7.415 *Control of a domestic enterprise by a French enterprise.* Article 5 of the convention provides that if a French enterprise by reason of its control of a domestic business imposes conditions different from those which would result from normal business relations between independent enterprises, the accounts between the enterprises will be adjusted so as to ascertain the true net income of the domestic enterprise. The purpose is to place the controlled domestic enterprise on a tax parity with an uncontrolled domestic enterprise by determining, according to the standard of an uncontrolled enterprise, the true net income from the property and business of the controlled enterprise. The convention contemplates that if the accounting records do not truly reflect the net income from the property and business of such domestic enterprise the Commissioner of Internal Revenue shall intervene and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions of any item or element affecting net income as between such domestic enterprise and the French enterprise by which it is controlled or directed, determine the true net income of the domestic enterprise. The provisions of § 29.45-1 of this chapter (Regulation 111), shall, in so far as applicable, be followed in the determination of the net income of the domestic business.

§ 7.416 *Income from operation of ships or aircraft.* The income derived by a French enterprise from the operation of ships documented under the laws of France, or of aircraft registered in France, is under Article 6 of the convention exempt from United States income tax. However, the profits derived by such enterprise from the operation of ships or aircraft, if any, not so documented or registered are treated as are industrial and commercial profits generally. See Article 3 of the convention and § 7.414.

§ 7.417 *Income from real property, including mineral royalties.* Income of whatever nature derived by a nonresident alien individual who is a resident of France, or by a French corporation or other French entity from real property situated in the United States, including gains derived from the sale of such property and royalties in respect of the operation of mines, quarries, or other natural resources situated in the United States, is not exempted from taxation by the convention. The treatment of such income for taxation purposes is governed by those provisions of the Internal Revenue Code applicable generally to the taxation of nonresident aliens and foreign corporations.

§ 7.418 *Patent and copyright royalties.* (a) Royalties derived from sources within the United States by a nonresident alien individual who is a resident of France, or by a French corporation or other French entity, as consideration for the right to use copyrights, patents, secret processes and formulae, trademarks and other analogous rights, are exempt from Federal income tax under Article 7 of the convention, provided that such individual, corporation, or other entity has no permanent establishment within the United States at any time during the taxable year in which such income is so derived. Thus, a nonresident alien who is a resident of France, rendering personal services within the United States, is not subject to tax with respect to such royalties even though he is engaged in trade or business in the United States by reason of rendition of such services so long as he has no permanent establishment in the United States.

(b) To obviate withholding of tax at the source, the nonresident alien individual resident of France or the corporation or other entity organized under the laws of France, as the case may be, shall

notify by letter the person paying such income that the income is exempt from taxation under the provisions of the applicable convention and portocol. The letter of notification from an individual resident of France shall contain his address and a statement that he is a resident of France. The letter of notification from a corporation or other entity organized under the laws of France shall contain the address of its office or place of business and a statement that it is a corporation or other entity organized under the laws of France, shall be signed by an officer of such corporation or entity, and shall set forth his official title. In the case of royalties derived on or after January 1, 1945, the letter of notification shall also state that the individual resident of France, or corporation or other entity organized under the laws of France, as the case may be, does not have a permanent establishment in the United States and will not have such establishment in the United States at any time during the calendar year in which such royalties are paid. The recipient of the letter of notification shall immediately forward such letter or a copy thereof to the Commissioner of Internal Revenue, Withholding Returns Section, Washington 25, D. C.

§ 7.419 *Government wages, salaries, and similar compensation, pensions, and life annuities.* (a) Under Article 8 of the convention, wages, salaries, and similar compensation, and pensions paid by France, or by a political subdivision thereof, to individuals residing in the United States are exempt from Federal income tax. However, under the provisions of Article 14 A of the convention, such exemption shall not be construed as applying to recipients of such income who are citizens of the United States or alien residents who are not citizens of France.

(b) Under the provisions of the same article of the convention private pensions and life annuities derived from sources within the United States by nonresident alien individuals who are residents of France are exempt from Federal income tax. Such items of income are therefore not subject to the withholding provisions of the Internal Revenue Code. See paragraph IV of the protocol to the convention as to what constitutes life annuities. See, also, § 7.418 with respect to patent and copyright royalties as to the requirements necessary to avoid withholding of the tax at the source, which requirements are also applicable for the purposes of this section.

§ 7.420 *Compensation for labor or personal services*—(a) *General.* In general and subject to the provisions of Article 8 and Article 10 of the convention and paragraph (b) of this section, compensation for labor or personal services derived from sources within the United States by a nonresident alien who is a resident of France, is subject to tax in accordance with the provisions of the Internal Revenue Code applicable generally to nonresident aliens. The provisions of Article 9 do not disturb either the provisions of section 119 (a) (3) of the Internal Revenue Code, relating to source of compensation for labor or personal services, or the provisions of the Internal Revenue Code relating to the taxation of such compensation in the hands of a nonresident individual who is a resident of France.

(b) *Professional earnings.* Article 10 of the convention provides a special rule of taxation with respect to professional fees constituting income derived from sources within the United States by a resident of France who is a nonresident alien. Under such rule, such nonresident alien rendering professional services, such as medical, legal, engineering, and scientific services, is not subject to United States tax with respect to such compensation unless he has an office or other fixed place situated in the United States during the taxable year. Thus, such alien present in the United States during any part of the taxable year and rendering professional advice as a medical doctor or as a laywer or as an engineer, is not subject to Federal income tax on fees derived by him in such taxable year by reason of such services unless he maintains at some time during such taxable year an office or other fixed place in the United States incident to the practice of his profession. The exemption applies regardless of the length of time spent within the United States during the taxable year and regardless of the amount of the fees or professional charges resulting to such alien from such services. As to when an alien is regarded as a resident of the United States and hence outside the scope of the exemption, see § 29.211-2 of this chapter (Regulations 111).

§ 7.421 *Stocks, securities, and commodities.* Under Article 11 of the con-

vention, gains derived from the sale or exchange within the United States of stocks, securities, or commodities (if of a kind customarily dealt in on an organized commodity exchange) by a nonresident alien individual resident in France, or by a French corporation or other French entity, is exempt from Federal income tax unless such individual, corporation, or other entity has a permanent establishment in the United States. If, however, a permanent establishment is maintained in the United States, such gains are not so exempt even 'hough the sales or exchanges resulting in such gains were carried on directly from the home office of the taxpayer and not through the permanent establishment in the United States. As to what constitutes a permanent establishment, see § 7.413 (b) (1).

§ 7.422 *Remittances to students.* Under Article 12 of the convention, nonresident alien individuals who are residents of France and who are temporarily residing in the United States for the purposes of studying or for acquiring business experience, are exempt from Federal income tax upon amounts representing remittances from France for the purposes of their maintenance and studies.

§ 7.423 *Credit against United States tax liability for income tax paid to France.* For the purpose of avoidance of double taxation, Article 14 A of the convention provides that, on the part of the United States, there shall be allowed against the United States income and excess profits tax liabilities a credit for any income, war-profits, or excess profits taxes paid to France by United States citizens or domestic corporations. Such principle also applies in the case of a citizen of France residing in the United States. Such credit, however, is subject to the limitations provided in section 131 of the Internal Revenue Code (relating to the credit for foreign taxes) and section 729 of such Code (relating to laws applicable). See §§ 29.131–1 to 29.131–8, of this chapter (Regulations 111) and 26 CFR, 1938 ed., Supps., 35.729–1 to 35.729–3 (Regulations 112).

§ 7.424 *Adjustment of tax liability of residents of France and French corporations.* Article 18 of the convention confers upon the Commissioner authority to adjust under the Revenue Act of 1936 the tax liability for taxable years beginning prior to January 1, 1936, of non-resident alien residents of France, and French corporations, in any case in which such tax liability remained unpaid on January 1, 1945. Such provision, however, will not apply in any case unless:

(a) The Commissioner is satisfied that the additional income tax involved did not arise by reason of fraud with intent to evade the tax on the part of the taxpayer concerned; and

(b) The taxpayer files, prior to January 1, 1947, with the Commissioner a sworn statement showing for each year involved and for such other years as the Commissioner may require, (1) by items and classes of income the amounts of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical income, gains, profits, and income derived from sources within the United States; (2) the business transactions, if any, carried on in the United States by or in behalf of the taxpayer during each of such years; and (3) such further information as the Commissioner may require in the particular case.

§ 7.425 *Reciprocal administrative assistance*—(a) *General.* (1) By Article 20 of the convention, the United States and France adopt the principle of exchange of information for use in the determination and assessment of the taxes with which the convention is concerned. Pursuant to such principle, every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042C for the calendar year 1945 and each subsequent calendar year, in addition to withholding return Form 1042, with respect to dividends, interest, royalties, rents, salaries, wages, pensions, and annuities, or other fixed or determinable annual or periodical income paid to persons whose addresses are in France whether or not tax has been withheld with respect to such income. There shall be reported on Form 1042C not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns, Form 1012, and there shall be shown on such return items of income paid to such addressees even though such items are exempt from tax under the convention, as, for example, certain royalties.

(2) The information and correspondence relating to exchange of information may be transmitted direct by the Secretary to the Minister.

(b) *Information to be furnished in due course.* In accordance with the provisions of Article 21 of the convention, the Secretary shall forward to the Minister as soon as practicable after the close of the calendar year 1945 and of each calendar year thereafter during which the convention is in effect, the names and addresses of all persons whose addresses are within France and who derive from sources within the United States, dividends, interest, rents, royalties, salaries, wages, pensions, and annuities, or other fixed or determinable annual or periodical profits and income showing the amounts of such profits and income in the case of each addressee. For these purposes, the transmission to the Minister of information return, Form 1042C, as provided in paragraph (a) of this section for the calendar year 1945 and subsequent calendar years shall constitute a compliance with the provisions of Article 21 of the convention and of this subpart.

(c) *Information in specific cases.* Under the provisions of Article 22 of the convention, the Secretary shall furnish (if request therefor is made by the Minister through diplomatic channels) to the Minister such information, relative to the tax liability to France of any person (other than a citizen of the United States or a United States domestic corporation or other United States domestic entity), as is available to, or may be obtained by, the Secretary under the revenue laws of the United States.

§ 7.426 *Reciprocal regulations.* Article 26 of the convention provides that the United States and France may prescribe (a) regulations for the purpose of carrying the convention into effect within the respective countries and (b) reciprocal rules relating to the exchange of information.

SUBPART—UNITED KINGDOM

TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1944

AUTHORITY: §§ 7.500 to 7.511 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 7.500 to 7.511 contained in Treasury Decision 5532, 11 F. R. 9334. Exception is noted following section affected.

§ 7.500 *Introductory.* (a) The income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed April 16, 1945, and effective (for the purposes of United States income and excess profits taxes) for taxable years beginning on or after January 1, 1945 (referred to in this subpart as the convention), provides in part as follows:

ARTICLE I

(1) The taxes which are the subject of the present Convention are:

(a) In the United States of America: The Federal income taxes, including surtaxes and excess profits taxes (hereinafter referred to as United States tax).

(b) In the United Kingdom of Great Britain and Northern Ireland: The income tax (including surtax), the excess profits tax and the national defense contribution (hereinafter referred to as United Kingdom tax).

(2) The present Convention shall also apply to any other taxes of a substantially similar character imposed by either Contracting Party subsequently to the date of signature of the present Convention or by the government of any territory to which the present Convention is extended under Article XXII

ARTICLE II

(1) In the present Convention, unless the context otherwise requires:

(a) The term "United States" means the United States of America, and when used in a geographical sense means the States, the Territories of Alaska and of Hawaii, and the District of Columbia.

(b) The term "United Kingdom" means Great Britain and Northern Ireland, excluding the Channel Islands and the Isle of Man.

(c) The terms "territory of one of the Contracting Parties" and "territory of the other Contracting Party" mean the United States or the United Kingdom as the context requires.

(d) The term "United States corporation" means a corporation, association or other like entity created or organized in or under the laws of the United States.

(e) The term "United Kingdom corporation" means any kind of juridical person created under the laws of the United Kingdom.

(f) The terms "corporation of one Contracting Party" and "corporation of the other Contracting Party" means a United States corporation or a United Kingdom corporation as the context requires.

(g) The term "resident of the United Kingdom" means any person (other than a citizen of the United States or a United States corporation) who is resident in the United Kingdom for the purposes of United Kingdom tax and not resident in the United States for the purposes of United States tax. A corporation is to be regarded as resident in

the United Kingdom if its business is managed and controlled in the United Kingdom.

(h) The term "resident of the United States" means any individual who is resident in the United States for the purposes of United States tax and not resident in the United Kingdom for the purposes of United Kingdom tax, and any United States corporation and any partnership created or organized in or under the laws of the United States, being a corporation or partnership which is not resident in the United Kingdom for the purposes of United Kingdom tax.

(i) The term "United Kingdom enterprise" means an industrial or commercial enterprise or undertaking carried on by a resident of the United Kingdom.

(j) The term "United States enterprise" means an industrial or commercial enterprise or undertaking carried on by a resident of the United States.

(k) The terms "enterprise of the Contracting Parties" mean a United States enterprise or a United Kingdom enterprise, as the context requires.

(l) The term "permanent establishment" when used with respect to an enterprise of one of the Contracting Parties means a branch, management, factory or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf. An enterprise of one of the Contracting Parties shall not be deemed to have a permanent establishment in the territory of the other Contracting Party merely because it carries on business dealings in the territory of such other Contracting Party through a bona fide commission agent, broker or custodian acting in the ordinary course of his business as such. The fact that an enterprise of one of the Contracting Parties maintains in the territory of the other Contracting Party a fixed place of business exclusively for the purchase of goods or merchandise shall not of itself constitute such fixed place of business a permanent establishment of such enterprise. The fact that a corporation of one Contracting Party has a subsidiary corporation which is a corporation of the other Contracting Party or which is engaged in trade or business in the territory of such other Contracting Party (whether through a permanent establishment or otherwise) shall not of itself constitute that subsidiary corporation a permanent establishment of its parent corporation.

(2) For the purposes of Articles VI, VII, VIII, IX and XIV a resident of the United Kingdom shall not be deemed to be engaged in trade or business in the United States in any taxable year unless such resident has a permanent establishment situated therein in such taxable year. The same principle shall be applied, mutatis mutandis, by the United Kingdom in the case of a resident of the United States.

(3) In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention.

ARTICLE VI

(1) The rate of United States tax on dividends derived from a United States corporation by a resident of the United Kingdom who is subject to United Kingdom tax on such dividends and not engaged in trade or business in the United States shall not exceed 15 percent: *Provided,* That such rate of tax shall not exceed five percent if such resident is a corporation controlling, directly or indirectly, at least 95 percent of the entire voting power in the corporation paying the dividend, and not more than 25 percent of the gross income of such paying corporation is derived from interest and dividends, other than interest and dividends received from its own subsidiary corporations. Such reduction of the rate to five percent shall not apply if the relationship of the two corporations has been arranged or is maintained primarily with the intention of securing such reduced rate.

(2) Dividends derived from sources within the United Kingdom by an individual who is (a) a resident of the United States, (b) subject to United States tax with respect to such dividends, and (c) not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom surtax.

(3) Either of the Contracting Parties may terminate this Article by giving written notice of termination to the other Contracting Party, through diplomatic channels, on or before the thirtieth day of June in any year after the year 1945, and in such event paragraph (1) hereof shall cease to be effective as to United States tax on and after the first day of January, and paragraph (2) hereof shall cease to be effective as to United Kingdom tax on and after the 6th day of April, in the year next following that in which such notice is given.

ARTICLE VII

(1) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax on such interest and not engaged in trade or business in the United States, shall be exempt from United States tax; but such exemption shall not apply to such interest paid by a United States corporation to a corporation resident in the United Kingdom controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation.

(2) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) derived from sources within the

United Kingdom by a resident of the United States who is subject to United States tax on such interest and not engaged in trade or businèss in the United Kingdom, shall be exempt from United Kingdom tax; but such exemption shall not apply to such interest paid by a corporation resident in the United Kingdom to a United States corporation controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation.

ARTICLE VIII

(1) Royalties and other amounts paid as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trademarks, and other like property, and derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax on such royalties or other amounts and not engaged in trade or business in the United States, shall be exempt from United States tax.

(2) Royalties and other amounts paid as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trademarks, and other like property, and derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such royalties or other amounts and not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom tax.

(3) For the purposes of this Article the term "royalties" shall be deemed to include rentals in respect of motion picture films.

ARTICLE IX

(1) The rate of United States tax on royalties in respect of the operation of mines or quarries or of other extraction of natural resources, and on rentals from real property or from an interest in such property, derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax with respect to such royalties or rentals and not engaged in trade or business in the United States, shall not exceed 15 percent: *Provided*, That any such resident may elect for any taxable year to be subject to United States tax as if such resident were engaged in trade or business in the United States.

(2) Royalties in respect of the operation of mines or quarries or of other extraction of natural resources, and rentals from real property or from an interest in such property, derived from sources within the United Kingdom by an individual who is (a) a resident of the United States, (b) subject to United States tax with respect to such royalties and rentals, and (c) not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom surtax.

ARTICLE X

(1) Any salary, wage, similar remuneration, or pension, paid by the Government of the United States to an individual (other than a British subject who is not also a citizen of the United States) in respect of services rendered to the United States in the discharge of governmental functions, shall be exempt from United Kingdom tax.

(2) Any salary, wage, similar remuneration, or pension, paid by the Government of the United Kingdom to an individual (other than a citizen of the United States who is not also a British subject) in respect of services rendered to the United Kingdom in the discharge of governmental functions, shall be exempt from United States tax.

(3) The provisions of this Article shall not apply to payments in respect of services rendered in connection with any trade or business carried on by either of the Contracting Parties for purposes of profit.

ARTICLE XII

(1) Any pension (other than a pension to which Article X applies), and any life annuity, derived from sources within the United States by an individual who is a resident of the United Kingdom shall be exempt from United States tax.

(2) Any pension (other than a pension to which Article X applies), and any life annuity, derived from sources within the United Kingdom by an individual who is a resident of the United States shall be exempt from United Kingdom tax.

(3) The term "life annuity" means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in consideration of money paid.

ARTICLE XXIII

(1) The present Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) Upon exchange of ratifications, the present Convention shall have effect

(a) as respects United States tax, for the taxable years beginning on or after the first day of January 1945;

(b) (i) as respects United Kingdom income tax, for the year of assessment beginning on the 6th day of April 1945 and subsequent years; (ii) as respects United Kingdom surtax, for the year of assessment beginning on the 6th day of April 1944 and subsequent years; and (iii) as respects United Kingdom excess profits tax and national defence contribution, for any chargeable accounting period beginning on or after the first day of April 1945 and for the unexpired portion of any chargeable accounting period current at that date.

ARTICLE XXIV

(1) The present Convention shall continue in effect indefinitely but either of the Contracting Parties may, on or before the 30th day of June in any year after the year 1946, give to the other Contracting Party, through diplomatic channels, notice of termination

and, in such event, the present Convention shall cease to be effective

(a) as respects United States tax, for the taxable years beginning on or after the first day of January in the year next following that in which such notice is given;

(b) (i) as respects United Kingdom income tax, for any year of assessment beginning on or after the 6th day of April in the year next following that in which such notice is given; (ii) as respects United Kingdom surtax, for any year of assessment beginning on or after the 6th day of April in the year in which such notice is given; and (iii) as respects United Kingdom excess profits tax and national defence contribution, for any chargeable accounting period beginning on or after the first day of April in the year next following that in which such notice is given and for the unexpired portion of any chargeable accounting period current at that date.

(2) The termination of the present Convention or of any Article thereof shall not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting Parties.

* * * * *

(b) As used in this subpart, unless the context otherwise requires, the terms defined in the above articles of the convention shall have the meanings so assigned to them.

§ 7.501 *Dividends*—(a) *General.* (1) The rate of tax imposed by section 211 (a) of the Internal Revenue Code (relating to nonresident alien individuals not engaged in trade or business within the United States) and by section 231 (a) of the Internal Revenue Code (relating to foreign corporations not engaged in trade or business within the United States) is 30 percent. Such rate in the case of dividends received in any taxable year beginning on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom or a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United Kingdom, is reduced to 15 percent under the provisions of Article VI of the convention if such alien or corporation:

(i) Is subject to United Kingdom tax on such dividends, and

(ii) At no time during the taxable year in which such dividend was so received was engaged in trade or business within the United States.

(2) For the purposes of Articles VI, VII, VIII and IX of the convention, a nonresident alien or foreign corporation is not engaged in trade or business within the United States unless such alien or foreign corporation has a permanent establishment situated therein at some time in the taxable year. Thus, if a nonresident alien who is a resident of the United Kingdom, performs personal services within the United States during the calendar year 1945, has at no time during such year a permanent establishment within the United States, and is subject to United Kingdom tax with respect to a dividend derived by him from United States sources, he is entitled to the reduced rate of tax with respect to such dividend, as provided in Article VI of the convention even though by reason of his having rendered personal services within the United States he is engaged in trade or business therein in that year within the meaning of section 211 (b) of the Internal Revenue Code. The fact that the payee of the dividend is, owing to the application of reliefs or exemptions under United Kingdom revenue laws, not required to pay United Kingdom tax on such dividend does not prevent the application of the reduction of the rate of United States tax with respect to such dividend. If the dividend would have been subject to United Kingdom tax had the payee thereof derived sufficiently large an income to require payment of tax, then liability to United Kingdom tax exists for the purposes of the reduction in the rate of United States tax. As to what constitutes a permanent establishment, see Article II (1) (l) of the convention.

(3) In the case of dividends paid on or after January 1, 1945, by a corporation created under the laws of the United Kingdom no withholding of United States tax is required.

(b) *Dividends paid by a United States subsidiary corporation.* (1) Under the proviso of Article VI (1) of the convention, dividends paid by a domestic corporation to a foreign corporation controlling, directly or indirectly, at the time the dividend is paid 95 percent or more of the voting power in such domestic corporation, are subject to tax at the rate of only 5 percent, if (i) not more than 25 percent of the gross income of the domestic corporation paying the dividend for the three-year period immediately preceding the taxable year in which the divi-

dend is paid consists of dividends and interest (other than dividends and interest paid to such domestic corporation by its own subsidiary corporations, if any), and (2) the relationship between such domes- (ii) the relationship between such domestion has not been arranged or maintained primarily with the intention of securing such reduced rate of 5 percent.

(2) Thus, for example, the X Corporation is a domestic corporation, 97 percent of the entire voting stock of which is controlled by the Y Company, Ltd., a foreign corporation managed and controlled in the United Kingdom, not having a permanent establishment in the United States at any time during the calendar year 1945, and subject to United Kingdom tax with respect to any dividends received by it or credited to its account in the United States. The X Corporation makes its income tax returns on the calendar year basis and throughout each of the years 1942, 1943, and 1944 derived not more than 25 percent of its gross income from interest and dividends from corporations other than its own subsidiary corporations. The relationship between the X Corporation and the Y Company, Ltd., is a relationship arranged and maintained without reference to the reduced rate of 5 percent on dividends provided in the proviso in Article VI (1) of the convention. A dividend was paid by the X Corporation to the Y Company, Ltd., on July 1, 1945. The reduced rate of tax of 5 percent is applicable to such dividend.

(3) Any domestic corporation which claims or contemplates claiming that dividends paid or to be paid by it on or after January 1, 1945, are subject only to the 5 percent rate shall file, as soon as practicable, with the Commissioner of Internal Revenue, the following information: (i) The date and place of its organization; (ii) the location of the management and control of the foreign corporation to which the dividend is paid or to be paid; (iii) the number of outstanding shares of stock of the domestic corporation having voting power and the voting power thereof; (iv) the person or persons benficially owning such stock of the domestic corporation and their relationship to such foreign corporation; (v) the amount of gross income, by years, of the paying corporation for the three-year period immediately preceding the taxable year in which the dividend is paid; (vi) the amount of interest and dividends, by years, included in the gross income of the domestic corporation and the amount of interest and dividends, by years, received by such corporation from its subsidiary corporations, if any; and (vii) the relationship between the domestic corporation and the foreign corporation to which it pays the dividend.

(4) As soon as practicable after such information is filed, the Commissioner of Internal Revenue will determine whether the dividends concerned fall within the scope of the proviso of Article VI (1) of the convention and may authorize the release of excess tax withheld with respect to dividends which come within such proviso. In any case in which the Commissioner of Internal Revenue has notified such domestic corporation that it comes within such proviso, the reduced rate of 5 percent applies to any dividends subsequently paid by such corporation to the foreign corporation unless the stock ownership of the domestic corporation, or the character of its income, or the place of management and control of the corporation to which the dividend is paid, materially changes, and, if such change or changes occur, such corporation shall promptly notify the Commissioner of Internal Revenue of the then existing facts with respect to such stock ownership, income, and control.

(c) *Effect on withholding of address in United Kingdom.* For the purposes of withholding of the tax in the case of dividends, every nonresident alien (including a nonresident alien individual, fiduciary, or partnership) whose address is in the United Kingdom shall be deemed by United States withholding agents to be a resident of the United Kingdom and subject to United Kingdom tax and every corporation whose address is in the United Kingdom shall be deemed by such withholding agents to be a foreign corporation managed and controlled in the United Kingdom and subject to United Kingdom tax.

(d) *Rate of withholding.* (1) On and after September 5, 1946 (ten days after the date on which this subpart was filed with the Division of the Federal Register), withholding in the case of dividends paid to nonresident aliens and foreign corporations, whose addresses are in the United Kingdom, shall (except (i) in any case in which, prior to the date of payment of such dividend, the Commissioner of Internal Revenue has notified

the paying corporation that such dividend falls within the proviso of Article VI (1) of the convention, and (ii) in any case in which the Commissioner notifies the withholding agent that the reduced rate shall not apply) be at the rate of 15 percent.

(2) In the case of every dividend paid to a person whose address is in the United Kingdom, there shall be shown on the check or draft representing such dividend or on an accompanying statement, either in writing or stamped thereon by means of a rubber stamp or other suitable device, the rate of tax at which United States tax has been withheld from such dividend.

(3) In any case in which a custodian account is maintained with a bank in the United States by a nonresident alien or foreign corporation whose address is in the United Kingdom and such alien or corporation notifies its custodian that the reduced rate of tax of 15 percent should not apply to dividends paid by such custodian with respect to such account, the custodian shall withhold the tax at the rate of 30 percent with respect to such dividends at the source without regard to the reduced rate of withholding provided in this Treasury decision.

(4) The preceding provisions relative to residents of the United Kingdom and to foreign corporations managed and controlled in the United Kingdom are based upon the assumption that the payee is the actual owner of the capital stock from which the dividend is derived and consequently is the person liable to the tax upon such dividend. As to action by the recipient who is not the owner of the dividend, see § 7.507.

§ 7.502 *Interest*—(a) *General.* (1) Interest (other than interest falling within the scope of paragraph (b) of this section), whether on bonds, securities, notes, debentures, or any other form of indebtedness (including interest on obligations of the United States and on obligations of instrumentalities of the United States) received in any taxable year beginning on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom, or a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United Kingdom, is exempt from United States tax under the provisions of Article VII of the convention if such alien, or corporation:

(i) Is subject to United Kingdom tax on such interest, and

(ii) At no time during the taxable year in which such interest was so derived, had a permanent establishment situated within the United States.

(2) Such interest is, therefore, not subject to the withholding provisions of the Internal Revenue Code.

(3) To obviate withholding at the source in the case of coupon bond interest, the nonresident alien resident in the United Kingdom or the foreign corporation managed and controlled in the United Kingdom shall file, in duplicate, with each presentation of interest coupons for payment, Form 1001-UK. Such form shall be signed by the owner of the interest, trustee or agent, and shall show the name and address of the obligor, and the name and the address of the owner of such interest and the amount of such interest. Such form shall contain a statement that the owner is a resident of the United Kingdom or is a foreign corporation managed and controlled in the United Kingdom, and that the owner has no permanent establishment in the United States and is chargeable to the United Kingdom tax with respect to the income.

(4) The exemption from United States tax contemplated by Article VII of the convention, insofar as it concerns coupon bond interest, is an exemption applicable only to the owner of such interest. The person presenting such coupon or on whose behalf it is presented shall, for the purpose of the exemption, be deemed to be the owner of the interest only if he is, at the time the coupon is presented for payment, the owner of the bond from which the coupon has been detached. If the person presenting the coupon is not the owner of the bond, Form 1001, and not Form 1001-UK, shall be executed.

(5) The original and duplicate ownership certificates, Form 1001-UK, must be forwarded to the Commissioner with the quarterly return, Form 1012, as provided in existing regulations with respect to Form 1001. See § 29.143-7 of this chapter (Regulations 111). Form 1001-UK need not be listed on Form 1012.

(6) In the case of interest coupons presented in the United Kingdom by a

nonresident alien or by a foreign corporation, not chargeable to United Kingdom tax in respect of such interest, ownership certificates, Form 1001, shall be filed as provided in existing regulations without reference to the provisions of the convention. See § 29.143-4 of this chapter (Regulations 111).

(7) To obviate withholding at the source in the case of interest other than interest payable by means of coupons, the nonresident alien who is a resident of the United Kingdom, or the foreign corporation managed and controlled in the United Kingdom, shall file, in duplicate, with the withholding agent in the United States, Form 1001A-UK. Such form shall be signed by the owner of the income, trustee or agent, and shall show the name and address of the obligor and the name and the address of the owner of such interest. Such form shall contain a statement that the owner is a resident of the United Kingdom or is a foreign corporation managed and controlled in the United Kingdom, and that the owner has no permanent establishment in the United States and is chargeable to United Kingdom tax with respect to such interest. The degree of liability to United Kingdom tax sufficient to entitle the owner of the interest (including coupon bond interest) to exemption from withholding is the same as that with respect to dividends. See § 7.501 (a).

(8) Form 1001A-UK must be filed for each three calendar year period and the first such form filed by the taxpayer with any withholding agent should be filed not later than 20 days preceding the date of the first payment of income in such period. If the taxpayer files such form with the withholding agent in the calendar year 1946 or in any subsequent calendar year no additional Form 1001A-UK need be filed prior to the end of the two calendar years immediately following the calendar year in which such form is so filed unless the Commissioner notifies the withholding agent that an additional Form 1001A-UK must be filed by the taxpayer at an earlier date.

(9) The duplicate of Form 1001A-UK should be immediately forwarded by the withholding agent to the Commissioner of Internal Revenue, Records Division, Washington 25, D. C.

(10) In the case of interest paid on or after January 1, 1945, by a corporation created under the laws of the United Kingdom no withholding of the United States tax is required.

(b) *Exemption not applicable to interest paid by subsidiary corporation to its parent corporation.* Article VII (1) of the convention provides in part that the exemption from United States tax of interest paid to residents of the United Kingdom (as defined in Article II (1) (g) of the convention) shall not apply to interest paid by a domestic corporation to a foreign corporation managed and controlled in the United Kingdom if such foreign corporation controls, directly or indirectly, more than 50 percent of the voting power of all classes of stock of such domestic corporation. The exemption provisions of Article VII (1) of the convention have, therefore, no application to such interest. In any case in which (1) a foreign corporation managed and controlled in the United Kingdom derives interest from a domestic corporation and (2) the relationship existing between the foreign corporation and the domestic corporation is such as to render uncertain whether the exemption applies to such interest, neither Form 1001-UK nor Form 1001A-UK should be executed by the foreign corporation. In such case a statement of the facts should be filed with the Commissioner of Internal Revenue, Washington 25, D. C. As soon as practicable after such statement is filed the Commissioner of Internal Revenue will determine whether the interest involved is entitled to exemption under the provisions of Article VII (1) of the convention, and will notify such foreign corporation whether the exemption provided in Article VII (1) of the convention applies in such case. If in such case the Commissioner of Internal Revenue determines that such exemption applies, then Form 1001A-UK should be filed together with a copy of the letter from the Commissioner of Internal Revenue.

[T. D. 5532, 11 F. R. 9334, as amended by T. D. 5580, 12 F. R. 7826]

§ 7.503 *Patent and copyright royalties and film rentals.* (a) Royalties and other like amounts received in any taxable year beginning on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom or a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United

Kingdom, as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trade-marks, and other like property, are exempt from United States tax under the provisions of Article VIII of the convention if such alien or corporation:

(1) Is subject to United Kingdom tax on such royalties or other amounts, and

(2) At no time during the taxable year in which such royalty or other amounts were so received had a permanent establishment within the United States.

(b) Such items are, therefore, not subject to the withholding provisions of the Internal Revenue Code. For the purposes of Article VIII of the convention and of this section the terms "royalties" and "royalties and other like amounts" include rentals for the use of, or for the right to use, motion picture films. As to what constitutes a permanent establishment, see Article II (1) (l) of the convention.

(c) To obviate withholding at the source, the nonresident alien who is a resident of the United Kingdom, or the foreign corporation managed and controlled in the United Kingdom, shall file, in duplicate, with the withholding agent in the United States Form 1001A–UK. Such form shall be signed by the owner of the income, trustee or agent, and shall show the name and address of the payor of the royalty or other like amount, and the name and the address of the owner of such income. Such form shall contain a statement that the owner is a resident of the United Kingdom or is a foreign corporation managed and controlled in the United Kingdom, and that the owner has no permanent establishment in the United States and is chargeable to United Kingdom tax with respect to such income. The degree of liability to United Kingdom tax sufficient to entitle the payee of the income to exemption from withholding is the same as that with respect to dividends. See § 7.501 (a).

(d) The duplicate copy of Form 1001A–UK should be immediately forwarded by the withholding agent to the Commissioner of Internal Revenue, Records Division, Washington 25, D. C.

§ 7.504 *Real property rentals and natural resource royalties.* (a) The rate of tax imposed by section 211 (a) of the Internal Revenue Code (relating to nonresident alien individuals not engaged in trade or business within the United States) and by section 231 (a) of the Internal Revenue Code (relating to foreign corporations not engaged in trade or business within the United States) is 30 percent. Such rate in the case of real property rentals and royalties in respect of the operation of natural resources received on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom or a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United Kingdom, is reduced to 15 percent under the provisions of Article IX of the convention if such alien or corporation:

(1) Is subject to United Kingdom tax on such royalties or other amounts, and

(2) At no time during the taxable year in which such rental or royalty or other amount was so received, had a permanent establishment situated within the United States.

(b) As to what constitutes a permanent establishment, see Article II (1) (l) of the convention.

(c) In order to secure the benefit of the reduced rate of tax provided in Article IX of the convention at the time the real property rental or natural resource royalty is paid, the nonresident alien who is a resident of the United Kingdom, or the foreign corporation managed and controlled in the United Kingdom, shall file, in duplicate, with the withholding agent in the United States Form 1001A–UK. Such form shall be signed by the owner of the income, trustee or agent, and shall show the name and address of the payor of the rental or royalty, and the name and the address of the owner of such income. Such form shall contain a statement that the owner is a resident of the United Kingdom or is a foreign corporation managed and controlled in the United Kingdom, and that the owner has no permanent establishment in the United States, and is chargeable to United Kingdom tax with respect to such income. As to the degree of liability to United Kingdom tax sufficient to entitle the owner of the income to the reduced rate of 15 percent, see § 7.501 (a).

(d) The duplicate copy of Form 1001A–UK should be immediately forwarded by

the withholding agent to the Commissioner of Internal Revenue, Records Division, Washington 25, D. C.

§ 7.505 *Pensions and life annuities.* (a) Article XII of the convention provides in part that pensions (other than pensions paid by the United States) and life annuities derived on or after January 1, 1945 from sources within the United States by a nonresident alien individual who is a resident of the United Kingdom shall be exempt from United States tax.

(b) The person paying such income should be notified by letter from the resident of the United Kingdom that the income is exempt from taxation under the provisions of the convention. Such letter shall contain the address of the individual. The letter of notification, or a copy thereof, should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Records Division, Washington 25, D. C. Such letter shall constitute authorization to the payor of the income to pay such income without deduction of the tax at the source unless the Commissioner subsequently notifies such payor that the tax should be withheld with respect to payments made after such notification.

§ 7.506 *Release of excess tax withheld at source*—(a) *General.* (1) In order to bring the convention into force and effect at the earliest practicable date, the reduced rate of tax of 15 percent to be withheld at the source on dividends, natural resource royalties, and real property rentals, and exemption from tax otherwise withheld at the source on interest, patent royalties, copyright royalties, film rentals and the like, are hereby made effective beginning January 1, 1946, in any case in which such dividends, natural resource royalties, real property rentals, interest, patent royalties, copyright royalties, film rentals, and the like are derived from sources within the United States by (i) a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom, or (ii) a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United Kingdom.

(2) Accordingly, in the case of every nonresident alien (including a nonresident alien individual, fiduciary, and partnership) whose address is in the United Kingdom, and every foreign corporation whose address is in the United Kingdom, where tax at the rate of 30 percent has been withheld on or after January 1, 1946, from dividends, there shall be released by the withholding agent and paid over to the person from whom it was withheld an amount equal to 15 percent of such dividend.

(3) In the case of every such taxpayer who furnishes to the withholding agent Form 1001A–UK as prescribed in §§ 7.502, 7.503, or 7.504 where tax at the rate of 30 percent has been withheld on or after January 1, 1946, there shall be released by the withholding agent and paid over to the person from whom it was withheld an amount equal to (i) the amount so withheld in the case of interest (as to coupon bond interest, see next paragraph), patent royalties, copyright royalties, film rentals and the like, and (ii) any amount so withheld in excess of 15 percent of the amount of natural resource royalties and real property rentals.

(4) In the case of every such taxpayer described in the first paragraph of this paragraph who furnishes to the withholding agent Form 1001–UK, in duplicate, where tax at the rate of 28 or 30 percent, as the case may be, has been withheld on or after January 1, 1946, from coupon bond interest, there shall be released by the withholding agent and paid over to the person from whom it was withheld an amount equal to the tax withheld from such interest. Form 1001–UK used for this purpose should be clearly marked "Substitute" in order to replace Forms 1001 previously filed. One Form 1001–UK, in duplicate, may be used to replace two or more Forms 1001. The form marked "Substitute" is to be used solely for the release of excess tax withheld in 1946. The use of Form 1001–UK for the purpose of exemption upon presentation of interest coupons is set forth in § 7.502 (a).

(5) As to refund of excess tax withheld during the calendar year 1945, see § 7.511.

(b) *Pensions and life annuities.* (1) In order to bring the convention into force and effect at the earliest practicable date the exemption from tax otherwise withheld at the source on pensions (other than pensions paid by the United States) and life annuities is made effective beginning January 1, 1946, in any case in which such pensions and life annuities are derived from sources within the United States by a nonresident alien in-

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dividual who is a resident of the United Kingdom.

(2) The person paying such income should be notified by letter from the resident of the United Kingdom that the income is exempt from taxation under the provisions of Article XII of the convention. See § 7.505. Such letter shall constitute authorization to the payor of the income to release the tax withheld on or after January 1, 1946 from such pensions and life annuities.

(c) *Subsidiary's dividends.* With respect to a dividend paid on or after January 1, 1945, by a domestic corporation to a foreign corporation whose address is in the United Kingdom, tax shall be withheld at the rate of 15 percent unless prior to the date of payment of such dividend the Commissioner of Internal Revenue has notified the paying corporation that such dividend falls within the scope of the proviso of Article VI (1) of the convention. As soon as practicable after information required under § 7.501 (b) is filed, the Commissioner of Internal Revenue will determine whether the dividend involved falls within the scope of such proviso and may authorize the release of the excess tax withheld with respect to dividends which come within the scope of such proviso.

§ 7.507 *Addressee not actual owner.* (1) If the recipient in the United Kingdom of the dividend is a nominee or agent through whom the dividend flows to a person other than the person described in § 7.501 (a) as being entitled to the reduced rate of tax of 15 percent provided in Article VI of the convention, such recipient in the United Kingdom will withhold an additional tax equivalent to 15 percent of the gross dividend prior to diminution by the 15 percent previously deducted in the United States.

(2) The amounts so withheld by the withholding agent in the United Kingdom will, on or before the 15th day after the close of the calendar year quarter in which such withholding takes place, be deposited with the United Kingdom Board of Inland Revenue, without converting such amounts into dollars. Each withholding agent making such deposit will accompany such deposit with the appropriate British form executed as required by the Board of Inland Revenue. The Board of Inland Revenue have arranged that they will, on or before the end of the calendar month in which such deposit is so made with the Board, remit by draft in United States dollars the amounts so deposited, to the Collector of Internal Revenue, Baltimore, Maryland, U. S. A., together with the aggregate of any other amounts of United States tax withheld by the Board, forwarding with such draft the appropriate British form filed with the Board by the United Kingdom withholding agents.

(3) Fiduciaries and partnerships with an address in the United Kingdom are accorded the benefit of the reduced rate of withholding with respect to dividends. If, however, the fiduciary or partnership is acting as a nominee or agent receiving the dividend for or on behalf of a person other than a person described in § 7.501 (a) as being entitled to the reduced rate of tax, an additional tax equal to 15 percent of the gross dividend prior to its diminution by the 15 percent deducted in the United States will be deducted by such fiduciary or partnership and treated as provided in the immediately preceding paragraph.

(4) In any case in which the fiduciary or partnership receives a dividend from a United States domestic corporation, if a beneficiary of such fiduciary or a partner in such partnership is a nonresident alien not chargeable to United Kingdom tax with respect to the portion of such dividend included in such beneficiary's share of the distributable income of such fiduciary (if such fiduciary itself is not chargeable to United Kingdom tax on such dividend), or in the distributive share of such partner in such partnership's income, as the case may be, the fiduciary or partnership will withhold an additional tax equal to 15 percent of the amount of such dividend so included.

§ 7.508 *Return of tax withheld and information return with respect to persons whose addresses are in the United Kingdom.* Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042D, in addition to the withholding return, Form 1042, for the calendar year 1946 and each subsequent calendar year, with respect to: (a) dividends from which a tax of 15 percent was withheld from persons whose addresses are in the United Kingdom (5 percent in the case of dividends falling within the scope of the proviso of Article VI (1) of the convention); (b) real property rentals and natural resource royalties from which a tax of 15 percent was withheld from persons

whose addresses are in the United Kingdom; (c) royalties and like amounts and interest (other than coupon bond interest reported on Form 1001-UK) from which no tax was withheld from persons who have furnished to the withholding agent Form 1001A-UK; and (d) all other fixed or determinable annual or periodical income paid to such persons.

§ 7.509 *Beneficiaries of a domestic estate or trust.* A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust, shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Articles VI, VII, VIII, and IX of the convention with respect to dividends, interest, royalties, natural resource royalties, and rentals from real property to the extent such item or items are included in his distributive share of income of such estate or trust. In such case such beneficiary must, in order to be entitled to the exemption or reduction in the rate of tax, execute Form 1001A-UK and file such form with the fiduciary of such estate or trust in the United States.

§ 7.510 *Refund of excess tax withheld.* (a) If the tax withheld at the source upon dividends, interest, royalties, natural resource royalties, real property rentals, pensions or life annuities paid during the calendar year 1945 is in excess of the tax due from the taxpayer under the convention, it will be necessary for the taxpayer, in order to compute the tax properly, to file an income tax return, Form 1040NB (United Kingdom), for individuals, and Form 1120NB United Kingdom), for corporations, for such taxable year. The taxpayer's total fixed or determinable annual or periodical income from sources within the United States should be reported on such return and in the event securities are held in the name of a person other than the actual owner, the name of such person should be furnished. There shall be included in such return the following statements:

(1) That the taxpayer is a nonresident alien (including a nonresident alien individual, fiduciary, or partnership) resident in the United Kingdom or is a foreign corporation managed and controlled in the United Kingdom;

(2) That the taxpayer had a permanent establishment in the United States at no time during the taxable year in which the income was received;

(3) That the taxpayer is subject to United Kingdom income tax upon the income with respect to which the benefits of the convention are claimed.

However, the statements required by subparagraphs (2) and (3) of this paragraph are not applicable in the case of a taxpayer whose income from sources within the United States during the calendar year 1945 consisted exclusively of pensions or life annuities. As to additional information required in the case of a foreign corporation claiming a rate of 5 percent on dividends paid by its domestic subsidiary corporation, see § 7.501 (b).

(b) For the purposes of refund of excess tax withheld resulting from the tax convention, a properly executed return on Form 1040NB (United Kingdom) or Form 1120NB (United Kingdom) shall constitute a claim for refund or credit within the meaning of section 322 of the Internal Revenue Code for the amount of the overpayment disclosed by such return. An amended return, so-called, shall not be considered a claim for refund or credit. Any tax paid in excess of that due from the owner of the income will be refunded by the United States Government as required by law.

§ 7.511 *Canadian withholding agents.* (a) In the case of any dividend paid during 1946 or subsequent years to a recipient whose address is in Canada and who is a nominee, agent, or custodian through whom the dividend flows to a person whose address is in the United Kingdom, no withholding by such nominee or agent is required Any tax so withheld with respect to dividends on or after January 1, 1946, may be released to such person by the withholding agent in Canada. In any case in which interest, rents, or royalties are paid during 1946 or subsequent years to such nominee, agent, or custodian through whom such income flows to a resident of the United Kingdom, no withholding by such nominee, agent, or custodian is required if Form 1001-UK or Form 1001A-UK, as the case may be, is filed by such person with such nominee, agent, or custodian, in the same manner as provided in §§ 7.502, 7.503, and 7.504. The duplicate of Form 1001A-UK should be transmitted (attached to Form 1042) by the Canadian nominee, agent, or custodian to the Collector of Internal Revenue, Baltimore, Maryland. Any tax so withheld with respect to interest, rents or royalties on

or after January 1, 1946, paid to a resident of the United Kingdom who files Form 1001-UK or Form 1001A-UK, may be released to such person by the withholding agent in Canada.

(b) The provisions of §§ 7.10 to 7.17 (Treasury Decision 5157), approved June 27, 1942, are hereby amended to the extent that they are inconsistent with this section and as so amended are made applicable to payments of dividends, interest, rents, or royalties made by Canadian withholding agents on and after January 1, 1946.

REGULATIONS EFFECTIVE JULY 30, 1946

AUTHORITY: §§ 7.512 to 7.532 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 7.512 to 7.532 contained in Treasury Decision 5569, 12 F. R. 4569.

§ 7.512 *Introductory.* The income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed April 16, 1945, and supplementary protocol, signed at Washington on June 6, 1946, both of which were proclaimed by the President of the United States on July 30, 1946, and effective (for the purposes of United States income and excess profits taxes) for taxable years beginning on or after January 1, 1945 (referred to in this subpart as the convention), provide as follows:

ARTICLE I

(1) The taxes which are the subject of the present Convention are:

(a) In the United States of America: The Federal income taxes, including surtaxes and excess profits taxes (hereinafter referred to as United States tax).

(b) In the United Kingdom of Great Britain and Northern Ireland: The income tax (including surtax), the excess profits tax and the national defense contribution (hereinafter referred to as United Kingdom tax).

(2) The present Convention shall also apply to any other taxes of a substantially similar character imposed by either Contracting Party subsequently to the date of signature of the present Convention or by the government of any territory to which the present Convention is extended under Article XXII.

ARTICLE II

(1) In the present Convention, unless the context otherwise requires:

(a) The term "United States" means the United States of America, and when used in a geographical sense means the States, the Territories of Alaska and of Hawaii, and the District of Columbia.

(b) The term "United Kingdom" means Great Britain and Northern Ireland, excluding the Channel Islands and the Isle of Man.

(c) The terms "territory of one of the Contracting Parties" and "territory of the other Contracting Party" means the United States or the United Kingdom as the context requires.

(d) The term "United States corporation" means a corporation, association or other like entity created or organized in or under the laws of the United States.

(e) The term "United Kingdom corporation" means any kind of juridical person created under the laws of the United Kingdom.

(f) The terms "corporation of one Contracting Party" and "corporation of the other Contracting Party" mean a United States corporation or a United Kingdom corporation as the context requires.

(g) The term "resident of the United Kingdom" means any person (other than a citizen of the United States or a United States corporation) who is resident in the United Kingdom for the purposes of United Kingdom tax and not resident in the United States for the purposes of United States tax. A corporation is to be regraded as resident in the United Kingdom if its business is managed and controlled in the United Kingdom.

(h) The term "resident of the United States" means any individual who is resident in the United States for the purposes of United States tax and not resident in the United Kingdom for the purposes of United Kingdom tax, and any United States corporation and any partnership created or organized in or under the laws of the United States, being a corporation or partnership which is not resident in the United Kingdom for the purposes of United Kingdom tax.

(i) The term "United Kingdom enterprise" means an industrial or commercial enterprise or undertaking carried on by a resident of the United Kingdom.

(j) The term "United States enterprise" means an industrial or commercial enterprise or undertaking carried on by a resident of the United States.

(k) The terms "enterprise of one of the Contracting Parties" and "enterprise of the other Contracting Party" mean a United States enterprise or a United Kingdom enterprise, as the context requires.

(l) The term "permanent establishment" when used with respect to an enterprise of one of the Contracting Parties means a branch, management, factory or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf. An enterprise of one of the Contracting Parties shall not be deemed to have a permanent establishment in the territory of the other Contracting Party merely because it carries on business dealings in the

territory of such other Contracting Party through a bona fide commission agent, broker or custodian acting in the ordinary course of his business as such. The fact that an enterprise of one of the Contracting Parties maintains in the territory of the other Contracting Party a fixed place of business exclusively for the purchase of goods or merchandise shall not of itself constitute such fixed place of business a permanent establishment of such enterprise. The fact that a corporation of one Contracting Party has a subsidiary corporation which is a corporation of the other Contracting Party or which is engaged in trade or business in the territory of such other Contracting Party (whether through a permanent establishment or otherwise) shall not of itself constitute that subsidiary corporation a permanent establishment of its parent corporation.

(2) For the purposes of Articles VI, VII, VIII, IX and XIV a resident of the United Kingdom shall not be deemed to be engaged in trade or business in the United States in any taxable year unless such resident has a permanent establishment situated therein such taxable year. The same principle shall be applied, mutatis mutandis, by the United Kingdom in the case of a resident of the United States.

(3) In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention.

ARTICLE III

(1) A United Kingdom enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed upon the entire income of such enterprise from sources within the United States.

(2) A United States enterprise shall not be subject to United Kingdom tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United Kingdom through a permanent establishment situated therein. If it is so engaged, United Kingdom tax may be imposed upon the entire income of such enterprise from sources within the United Kingdom: *Provided,* That nothing in this paragraph shall affect any provisions of the law of the United Kingdom regarding the imposition of United Kingdom excess profits tax and national defence contribution in the case of inter-connected companies.

(3) Where an enterprise of one of the Contracting Parties is engaged in trade or business in the territory of the other Contracting Party through a permanent establishment situated therein, there shall be attributed to such permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment, and the profits so attributed shall, subject to the law of such other Contracting Party, be deemed to be income from sources within the territory of such other Contracting Party.

(4) In determining the industrial or commercial profits from sources within the territory of one of the Contracting Parties of an enterprise of the other Contracting Party, no profits shall be deemed to arise from the mere purchase of goods or merchandise within the territory of the former Contracting Party by such enterprise.

ARTICLE IV

Where an enterprise of one of the Contracting Parties, by reason of its participation in the management, control or capital of an enterprise of the other Contracting Party, makes with or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which would but for those conditions have accrued to one of the enterprises but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

ARTICLE V

(1) Notwithstanding the provisions of Articles III and IV of the present Convention, profits which an individual (other than a citizen of the United States) resident in the United Kingdom or a United Kingdom corporation derives from operating ships documented or aircraft registered under the laws of the United Kingdom, shall be exempt from United States tax.

(2) Notwithstanding the provisions of Articles III and IV of the present Convention, profits which a citizen of the United States not resident in the United Kingdom or a United States corporation derives from operating ships documented or aircraft registered under the laws of the United States, shall be exempt from United Kingdom tax.

(3) This Article shall be deemed to have superseded, on and after the first day of January 1945, as to United States tax, and on and after the 6th day of April, 1945, as to United Kingdom tax, the arrangements relating to reciprocal exemption of shipping profits from income tax effected between the Government of the United States and the Government of the United Kingdom by exchange of Notes dated August 11, 1924, November 18, 1924, November 26, 1924, January 15, 1925, February 13, 1925, and March 16, 1925, which shall accordingly cease to have effect.

ARTICLE VI

(1) The rate of United States tax on dividends derived from a United States corporation by a resident of the United Kingdom who is subject to United Kingdom tax on such dividends and not engaged in trade or business in the United States shall not exceed 15 percent: *Provided,* That such rate of tax shall not exceed five percent if such resident is a corporation controlling, directly or indirectly, at least 95 percent of the entire voting power in the corporation paying the dividend, and not more than 25 percent of the gross income of such paying corporation is derived from interest and dividends, other than interest and dividends received from its own subsidiary corporations. Such reduction of the rate to five percent shall not apply if the relationship of the two corporations has been arranged or is maintained primarily with the intention of securing such reduced rate.

(2) Dividends derived from sources within the United Kingdom by an individual who is (a) a resident of the United States, (b) subject to United States tax with respect to such dividends, and (c) not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom surtax.

(3) Either of the Contracting Parties may terminate this Article by giving written notice of termination to the other Contracting Party, through diplomatic channels, on or before the thirtieth day of June in any year after the year 1945, and in such event paragraph (1) hereof shall cease to be effective as to United States tax on and after the first day of January, and paragraph (2) hereof shall cease to be effective as to United Kingdom tax on and after the 6th day of April, in the year next following that in which such notice is given.

ARTICLE VII

(1) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax on such interest and not engaged in trade or business in the United States, shall be exempt from United States tax; but such exemption shall not apply to such interest paid by a United States corporation to a corporation resident in the United Kingdom controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation.

(2) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such interest and not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom tax; but such exemption shall not apply to such interest paid by a corporation resident in the United Kingdom to a United States corporation controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation.

ARTICLE VIII

(1) Royalties and other amounts paid as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trademarks, and other like property, and derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax on such royalties or other amounts and not engaged in trade or business in the United States, shall be exempt from United States tax.

(2) Royalties and other amounts paid as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulae, trade-marks, and other like property, and derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such royalties or other amounts and not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom tax.

(3) For the purposes of this Article the term "royalties" shall be deemed to include rentals in respect of motion picture films.

ARTICLE IX

(1) The rate of United States tax on royalties in respect of the operation of mines or quarries or of other extraction of natural resources, and on rentals from real property or from an interest in such property, derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax with respect to such royalties or rentals and not engaged in trade or business in the United States, shall not exceed 15 percent: *Provided,* That any such resident may elect for any taxable year to be subject to United States tax as if such resident were engaged in trade or business in the United States.

(2) Royalties in respect of the operation of mines or quarries or of other extraction of natural resources, and rentals from real property, or from an interest in such property, derived from sources within the United Kingdom by an individual who is (a) a resident of the United States, (b) subject to United States tax with respect to such royalties and rentals, and (c) not engaged in trade or business in the United Kingdom, shall be exempt from United Kingdom surtax.

ARTICLE X

(1) Any salary, wage, similar remuneration, or pension, paid by the Government of the United States to an individual (other than a British subject who is not also a citizen of the United States) in respect of services rendered to the United States in the discharge of governmental functions, shall be exempt from United Kingdom tax.

(2) Any salary, wage, similar remuneration, or pension, paid by the Government of the United Kingdom to an individual (other than a citizen of the United States who is not also a British subject) in respect of services rendered to the United Kingdom in the discharge of governmental functions, shall be exempt from United States tax.

(3) The provisions of this Article shall not apply to payments in respect of services rendered in connection with any trade or business carried on by either of the Contracting Parties for purposes of profit.

ARTICLE XI

(1) An individual who is a resident of the United Kingdom shall be exempt from United States tax upon compensation for personal (including professional) services performed during the taxable year within the United States if (a) he is present within the United States for a period or periods not exceeding in the aggregate 183 days during such taxable year, and (b) such services are performed for or on behalf of a person resident in the United Kingdom.

(2) An individual who is a resident of the United States shall be exempt from United Kingdom tax upon profits, emoluments or other remuneration in respect of personal (including professional) services performed within the United Kingdom in any year of assessment if (a) he is present within the United Kingdom for a period or periods not exceeding in the aggregate 183 days during that year, and (b) such services are performed for or on behalf of a person resident in the United States.

(3)[1] The provisions of this Article shall not apply to the compensation, profits, emoluments or other remuneration of public entertainers such as stage, motion picture or radio artists, musicians and athletes.

ARTICLE XII

(1) Any pension (other than a pension to which Article X applies), and any life annuity, derived from sources within the United States by an individual who is a resident of the United Kingdom shall be exempt from United States tax.

(2) Any pension (other than a pension to which Article X applies), and any life annuity, derived from sources within the United Kingdom by an individual who is a resident of the United States shall be exempt from United Kingdom tax.

(3) The term "life annuity" means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in consideration of money paid.

ARTICLE XIII

(1) Subject to section 131 of the United States Internal Revenue Code as in effect on the first day of January, 1945, United Kingdom tax shall be allowed as a credit against United States tax. For this purpose, the recipient of a dividend paid by a corporation which is a resident of the United Kingdom shall be deemed to have paid the United Kingdom income tax appropriate to such dividend if such recipient elects to include in his gross income for the purposes of United States tax the amount of such United Kingdom income tax.

(2) Subject to such provisions (which shall not affect the general principle hereof) as may be enacted in the United Kingdom, United States tax payable in respect of income from sources within the United States shall be allowed as a credit against any United Kingdom tax payable in respect of that income. Where such income is an ordinary dividend paid by a United States corporation, such credit shall take into account (in addition to any United States income tax deducted from or imposed on such dividend) the United States income tax imposed on such corporation in respect of its profits, and where it is a dividend paid on participating preference shares and representing both a dividend at the fixed rate to which the shares are entitled and an additional participation in profits, such tax on profits shall likewise be taken into account in so far as the dividend exceeds such fixed rate.

(3) For the purposes of this Article, compensation, profits, emoluments and other remuneration for personal (including professional) services shall be deemed to be income from sources within the territory of the Contracting Party where such services are performed.

ARTICLE XIV

A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets.

ARTICLE XV

Dividends and interest paid on or after the first day of January 1945 by a United Kingdom corporation shall be exempt from United States tax except where the recipient is a citizen of or a resident of the United States or a United States corporation.

ARTICLE XVI

A United Kingdom corporation shall be exempt from United States tax on its accumulated or undistributed earnings, profits, income or surplus, if individuals who are residents of the United Kingdom control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power in such corporation.

ARTICLE XVII

(1) The United States income tax liability for any taxable year beginning prior to January 1, 1936 of any individual (other than a

[1] Paragraph (3) of Article XI was deleted by the Protocol approved June 6, 1946.

citizen of the United States) resident in the United Kingdom, or of any United Kingdom corporation, remaining unpaid on the date of signature of the present Convention, may be adjusted on a basis satisfactory to the United States Commissioner of Internal Revenue: *Provided,* That the amount to be paid in settlement of such liability shall not exceed the amount of the liability which would have been determined if:

(a) The United States Revenue Act of 1936 (except in the case of a United Kingdom corporation in which more than 50 percent of the entire voting power was controlled, directly or indirectly, throughout the latter half of the taxable year, by citizens or residents of the United States), and

(b) Articles XV and XVI of the present Convention, had been in effect for such year. If the taxpayer was not, within the meaning of such Revenue Act, engaged in trade or business in the United States and had no office or place of business therein during the taxable year, the amount of interest and penalties shall not exceed 50 percent of the amount of the tax with respect to which such interest and penalties have been computed.

(2) The United States income tax unpaid on the date of signature of the present Convention for any taxable year beginning after the thirty-first day of December 1935 and prior to the first day of January 1945 in the case of an individual (other than a citizen of the United States) resident of the United Kingdom, or in the case of any United Kingdom corporation shall be determined as if the provisions of Articles XV and XVI of the present Convention had been in effect for such taxable year.

(3) The provisions of paragraph (1) of this Article shall not apply:

(a) Unless the taxpayer files with the Commissioner of Internal Revenue on or before the thirty-first day of December 1947 a request that such tax liability be so adjusted and furnishes such information as the Commissioner may require; or

(b) In any case in which the Commissioner is satisfied that any deficiency in tax is due to fraud with intent to evade the tax.

ARTICLE XVIII

A professor or teacher from the territory of one of the Contracting Parties who visits the territory of the other Contracting Party for the purpose of teaching, for a period not exceeding two years, at a university, college, school or other educational institution in the territory of such other Contracting Party shall be exempted by such other Contracting Party from tax on his remuneration for such teaching for such period.

ARTICLE XIX

A student or business apprentice from the territory of one of the Contracting Parties who is receiving full-time education or training in the territory of the other Contracting Party shall be exempted by such other Contracting Party from tax on payments made to him by persons within the territory of the former Contracting Party for the purposes of his maintenance, education or training.

ARTICLE XX

(1) The taxation authorities of the Contracting Parties shall exchange such information (being information available under the respective taxation laws of the Contracting Parties) as is necessary for carrying out the provisions of the present Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of the present Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any person other than those concerned with the assessment and collection of the taxes which are the subject of the present Convention. No information shall be exchanged which would disclose any trade secret or trade process.

(2) As used in this Article, the term "taxation authorities" means, in the case of the United States, the Commissioner of Internal Revenue or his authorized representative; in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorized representatives; and, in the case of any territory to which the present Convention is extended under Article XXII, the competent authority for the administration in such territory of the taxes to which the present Convention applies.

ARTICLE XXI

(1) The nationals of one of the Contracting Parties shall not, while resident in the territory of the other Contracting Party, be subjected therein to other or more burdensome taxes than are the nationals of such other Contracting Party resident in its territory.

(2) The term "nationals" as used in this Article means:

(a) In relation to the United Kingdom, all British subjects and British protected persons, from the United Kingdom or any territory with respect to which the present Convention is applicable by reason of extension made by the United Kingdom under Article XXII; and

(b) In relation to the United States, United States citizens, and all persons under the protection of the United States, from the United States or any territory to which the present Convention is applicable by reason of extension made by the United States under Article XXII;

and includes all legal persons, partnerships and associations deriving their status as such from, or created or organized under, the laws in force in any territory of the Contracting Parties to which the present Convention applies.

(3) In this Article the word "taxes" means taxes of every kind or description, whether

national, Federal, state, provincial or municipal.

ARTICLE XXII

(1) Either of the Contracting Parties may, at the time of exchange of instruments of ratification or thereafter while the present Convention continues in force, by a written notification of extension given to the other Contracting Party through diplomatic channels, declare its desire that the operation of the present Convention shall extend to all or any of its colonies, overseas territories, protectorates, or territories in respect of which it exercises a mandate, which impose taxes substantially similar in character to those which are the subject of the present Convention. The present Convention shall apply to the territory or territories named in such notification on the date or dates specified in the notification (not being less than sixy days from the date of the notification) or, if no date is specified in respect of any such territory, on the sixtieth day after the date of such notification, unless, prior to the date on which the Convention would otherwise become applicable to a particular territory, the Contracting Party to whom notification is given shall have informed the other Contracting Party in writing through diplomatic channels that it does not accept such notification as to that territory. In the absence of such extension, the present Convention shall not apply to any such territory.

(2) At any time after the expiration of one year from the entry into force of an extension under paragraph (1) of this Article, either of the Contracting Parties may, by written notice of termination given to the other Contracting Party through diplomatic channels, terminate the application of the present Convention to any territory to which it has been extended under paragraph (1), and in such event the present Convention shall cease to apply, six months after the date of such notice, to the territory or territories named therein, but without affecting its continued application to the United States, the United Kingdom or to any other territory to which it has been extended under paragraph (1) hereof.

(3) In the application of the present Convention in relation to any territory to which it is extended hy notification by the United States or the United Kingdom references to the "United States" or, as the case may be, the "United Kingdom" shall be construed as references to that territory.

(4) The termination in respect of the United States or the United Kingdom of the present Convention under Article XXIV or of Article VI shall, unless otherwise expressly agreed by both Contracting Parties, terminate the application of the present Convention or, as the case may be, that Article to any territory to which the Convention has been extended by the United States or the United Kingdom.

(5) The provisions of the preceding paragraphs of this Article shall apply to the Channel Islands and the Isle of Man as if they were colonies of the United Kingdom.

ARTICLE XXIII

(1) The present Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) Upon exchange of ratifications, the present Convention shall have effect

(a) As respects United States tax, for the taxable years beginning on or after the first day of January 1945;

(b) (i) As respects United Kingdom income tax, for the year of assessment beginning on the 6th day of April 1945 and subsequent years; (ii) as respects United Kingdom surtax, for the year of assessment beginning on the 6th day of April 1944 and subsequent years; and (iii) as respects United Kingdom excess profits tax and national defence contribution, for any chargeable accounting period beginning on or after the first day of April 1945 and for the unexpired portion of any chargeable accounting period current at that date.

ARTICLE XXIV

(1) The present Convention shall continue in effect indefinitely but either of the Contracting Parties may, on or before the 30th day of June in any year after the year 1946, give to the other Contracting Party, through diplomatic channels, notice of termination and, in such event, the present Convention shall cease to be effective

(a) As respects United States tax, for the taxable years beginning on or after the first day of January in the year next following that in which such notice is given;

(b) (i) As respects United Kingdom income tax, for any year of assessment beginning on or after the 6th day of April in the year next following that in which such notice is given; (ii) as respects United Kingdom surtax, for any year of assessment beginning on or after the 6th day of April in the year in which such notice is given; and (iii) as respects United Kingdom excess profits tax and national defense contribution, for any chargeable accounting period beginning on or after the first day of April in the year next following that in which such notice is given and for the unexpired portion of any chargeable accounting period current at that date.

(2) The termination of the present Convention or of any Article thereof shall not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting Parties.

In witness whereof the above-mentioned Plenipotentiaries have signed the present Convention and have affixed thereto their seals.

Done at Washington, in duplicate, on the 16th day of April, 1945.

For the Government of the United States of America:

E. R. STETTINIUS, Jr.

For the Government of the United Kingdom of Great Britain and Northern Ireland:

HALIFAX.

PROTOCOL

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland,

Desiring to conclude a supplementary Protocol modifying in certain respects the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income which was signed at Washington on April 16, 1945,

Have agreed as follows:

ARTICLE I

Paragraph (3) of Article XI of the Convention of April 16, 1945, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income shall be deemed to be deleted and of no effect.

ARTICLE II

This Protocol, which shall be regarded as an integral part of the said Convention, shall be ratified and the instruments of ratification thereof shall be exchanged at Washington.

In witness whereof the undersigned Plenipotentiaries, being authorized thereto by their respective Governments, have signed this Protocol and have affixed thereto their seals.

Done at Washington, in duplicate, this sixth day of June, 1946.

For the Government of the United States of America:

JAMES F. BYRNES,
Secretary of State,
of the United States of America.

For the Government of the United Kingdom of Great Britain and Northern Ireland:

JOHN BALFOUR,
His Majesty's Envoy Extraordinary and Minister Plenipotentiary in Washington.

§ 7.513 *Applicable provisions of the Internal Revenue Code.* (a) The Internal Revenue Code provides in part as follows:

CHAPTER 1—INCOME TAX

* * * * *

SEC. 22. GROSS INCOME

* * * * *

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

* * * * *

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

* * * * *

SEC. 62. RULES AND REGULATIONS

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this chapter.

(b) Pursuant to section 62 of the Internal Revenue Code, and other provisions of the internal revenue laws, the following regulations, which are designated as §§ 7.514 to 7.532, are hereby prescribed and all regulations inconsistent herewith are modified accordingly.

§ 7.514 *Scope of the convention.* (a) The primary purposes of the convention, to be accomplished on a reciprocal basis, are to avoid double taxation upon major items of income derived from sources in one country by persons resident in the other country, and to exchange fiscal information complementary to other provisions of the convention, including those relating to avoidance of double taxation.

(b) The specific classes of income from sources within the United States exempt under the convention from United States tax for taxable years beginning on or after January 1, 1945, are:

(1) Industrial and commercial profits of a United Kingdom enterprise having no permanent establishment in the United States (Article III);

(2) Income derived by a nonresident alien who is a resident of the United Kingdom, or by a United Kingdom corporation, from the operation of ships documented or aircraft registered, under the laws of the United Kingdom (Article V);

(3) Interest and royalties (including film rentals) derived by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom if such alien or corporation (i) is subject to United Kingdom tax upon such interest or royalties, and (ii) has no permanent establishment in the United States (but such exemption does not apply to interest paid to such foreign corporation controlling the corporation paying such interest) (Articles VII and VIII);

(4) Compensation and pensions paid by the United Kingdom to individuals (other than a citizen of the United States who is not also a British subject) for services rendered to the United Kingdom in the discharge of its governmental functions (Article X);

(5) Compensation for personal services derived by a nonresident alien who is a resident of the United Kingdom if (i) such alien is present in the United States for a period or periods not exceeding 183 days during the taxable year, and (ii) such services are performed for, or on behalf of, a person resident in the United Kingdom (Article XI);

(6) Pensions (other than pensions paid by the Government of the United States) and life annuities derived by nonresident alien individuals residing in the United Kingdom (Article XII);

(7) Gains from the sale or exchange of capital assets by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom, if such alien or corporation has no permanent establishment in the United States (Article XIV);

(8) Dividends and interest paid on or after January 1, 1945, by a corporation organized under the laws of the United Kingdom to a nonresident alien or foreign corporation (Article XV);

(9) Remuneration derived from teaching in the United States for a period of not more than two years by a professor or teacher who is from the territory of the United Kingdom, but who is temporarily present in the United States (Article XVIII);

(10) Remittances from sources within the United Kingdom received in the United States by a nonresident alien individual who is from the territory of the United Kingdom but who is temporarily present in the United States for the purpose of education, or training, such remittances being for the purpose of his maintenance, education, or training (Article XIX).

(c) The convention also reduces to 15 percent the rate of tax otherwise imposed upon dividends, natural resource royalties and rentals from real property, derived by a nonresident alien who is resident in the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom if such alien or corporation meets the tests of liability to United Kingdom tax and absence of permanent establishment in the United States set out in paragraph (c) of this section with respect to exemption in the case of interest and royalties.

(d) As to exemption from withholding of the tax at the source in the case of interest, royalties, pensions and life annuities and reduction in the rate of tax from 30 percent to 15 percent in the case of dividends, natural resource royalties, and rentals arising from real property, see Treasury Decision 5532 (26 CFR, 1946 Supp., 7.500 to 7.511).

(e) The convention does not affect the liability to United States income taxation of subjects of the United Kingdom who are residents of the United States except that such individuals are entitled to the benefits of Article X (relating to United Kingdom Government salaries and the like), of Article XIII (1) (relating to credit for United Kingdom income tax), and of Article XXI (relating to equality of taxation). Except as provided in Article X with respect to a citizen of the United States who is also a British subject and in Article XIII relating to the credit for income tax, the convention does not affect taxation by the United States of a citizen of the United States or of a domestic corporation, even though such citizen is resident in the United Kingdom and such corporation is managed and controlled in the United Kingdom. The convention has general application to foreign corporations managed and controlled in the United Kingdom even though such corporations are not organized under the laws of the United Kingdom, but, in the case of corporations organized under the laws of the United Kingdom but managed and controlled outside the United Kingdom, the provisions of Articles V, XV and XVI are applicable.

§ 7.515 *Definitions.* (a) As used in §§ 7.512 to 7.532, unless the context otherwise requires, the terms defined in the convention shall have the meanings so assigned to them. Any term used in §§ 7.512 to 7.532, which is not defined in the convention, but which is defined in the Internal Revenue Code shall be given the definition contained therein unless the context otherwise requires.

(b) As used in §§ 7.512 to 7.532:

(1) The term "permanent establishment" means a branch, management, factory, mine, oil well, farm, timberland, plantation, workshop, warehouse, office, or other fixed place of business. The fact that a foreign corporation managed and controlled in the United Kingdom has a domestic subsidiary corporation, or a foreign subsidiary corporation having

a branch in the United States, does not of itself constitute either subsidiary corporation a permanent establishment of the parent United Kingdom enterprise. The fact that a United Kingdom enterprise has business dealings in the United States through a bona fide commission agent, broker, or custodian, acting in the usual course of his business as such, or maintains in the United States an office or other fixed place of business used exclusively for the purchase of goods or merchandise, does not mean that such United Kingdom enterprise has a permanent establishment in the United States. If, however, a United Kingdom enterprise carries on business in the United States through an agent who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or if it has an agent who maintains within the United States a stock of merchandise from which he regularly fills orders on behalf of his principal, then such enterprise shall be deemed to have a permanent establishment in the United States. However, an agent having power to contract on behalf of his principal but only at fixed prices and under conditions determined by the principal does not constitute a permanent establishment of such principal. The mere fact that an agent (assuming he has no general authority to contract on behalf of his employer or principal) maintains samples or occasionally fills orders from incidental stocks of goods maintained in the United States will not constitute a permanent establishment within the United States. The mere fact that salesmen, employees of a United Kingdom enterprise, promote the sale of their employer's products in the United States or that such enterprise transacts business in the United States by means of mail-order activities, does not mean such enterprise has a permanent establishment therein. The term "permanent establishment" as used in the convention implies the active conduct therein of a business enterprise. The mere ownership, for example, of timberlands or a warehouse in the United States by a United Kingdom enterprise does not mean that such enterprise has a permanent establishment therein. As to the effect of the maintenance of a permanent establishment within the United States upon exemption from United States tax in the case of interest and royalties and reduction in the rate of United States tax in the case of dividends, natural resource royalties, and rentals arising from real property, see § 7.519.

(2) The term "enterprise" means any commercial or industrial undertaking whether conducted by an individual, partnership, corporation, or other entity. It includes such activities as manufacturing, merchandising, mining, processing, and banking. It does not include the rendition of personal services. Hence, a nonresident alien who is a resident of the United Kingdom and who renders personal services is not, merely by reason of such services, engaged in an enterprise within the meaning of the convention and his liability to United States tax is not affected by Article III of the convention.

(3) The term "United Kingdom enterprise" means an enterprise carried on by any person (including an individual and foreign corporation, whether or not a corporation organized under the laws of the United Kingdom, which is managed and controlled in the United Kingdom but not including a United States citizen or domestic corporation) who is a resident of the United Kingdom, regardless of whether such enterprise is carried on within or without the United Kingdom.

(4) The term "resident of the United Kingdom" means any nonresident alien (including an individual, fiduciary and partnership) resident in the United Kingdom for the purposes of United Kingdom income tax, and any foreign corporation managed and controlled from within the United Kingdom but not engaged in trade or business within the United States.

(5) The term "industrial and commercial profits", means profits arising from industrial, commercial, mercantile, manufacturing, and like activities of a United Kingdom enterprise as defined in this section. Such term does not include rentals, royalties, interest, dividends, fees, compensation for personal services, nor gains derived from the sale or exchange of capital assets. Such enumerated items of income are not governed by the provisions of Article III of the convention but are subject to the rules elsewhere set forth in the convention and in §§ 7.512 to 7.532.

§ 7.516 *Scope of convention with respect to determination of "industrial or commercial profits"*—(a) *General.* Article III of the convention adopts the

principle that an enterprise of one of the contracting parties shall not be taxable in the territory of the other contracting party upon its industrial or commercial profits unless it has a permanent establishment in the territory of the latter party. Hence, a United Kingdom enterprise is subject to United States tax upon its industrial and commercial profits to the extent of such profits from sources within the United States only if it has a permanent establishment within the United States. From the standpoint of Federal income taxation, the article has application only to a United Kingdom enterprise and to the industrial and commercial income thereof from sources within the United States. It has no application, for example, to compensation for labor or personal services performed in the United States nor to income derived from real property located in the United States, including rentals and royalties therefrom, nor to gains from the sale or disposition of such property, nor to interest, dividends, royalties, other fixed or determinable annual or periodical income and gains derived from the sale or exchange of capital assets.

(b) *No United States permanent establishment.* A nonresident alien individual who is a resident of the United Kingdom or a foreign corporation managed and controlled in the United Kingdom, having no permanent establishment in the United States is not, for taxable years beginning on or after January 1, 1945, subject to United States income tax upon industrial and commercial profits from sources within the United States. For example, if such United Kingdom enterprise sells, in 1946, merchandise, such as leather goods, porcelain, textiles, or liquors, through a bona fide commission agent or broker in the United States acting in the ordinary course of his business as such agent or broker, the resulting profits are, under the terms of Article III of the convention, exempt from United States income tax. Likewise no permanent establishment exists if such enterprise, through its sales agents in the United States, secures orders for its products, the sales being made in the United Kingdom.

(c) *United States permanent establishment.* A nonresident alien (including a nonresident alien individual, fiduciary and partnership) who is a resident of the United Kingdom or a foreign corporation managed and controlled in the United Kingdom, having a permanent establishment in the United States, is subject to tax upon industrial and commercial profits from sources within the United States to the same extent as are nonresident aliens and foreign corporations engaged in trade or business therein. In the determination of the income taxable to such alien or foreign corporation all industrial and commercial profits from sources within the United States shall be deemed to be allocable to the permanent establishment in the United States. Hence, for example, if a United Kingdom enterprise having a permanent establishment in the United States sells in the United States, through a commission agent therein goods produced in the United Kingdom, the resulting profits derived from United States sources from such transactions are allocable to such permanent establishment even though such transactions were carried on independently of such establishment. In determining industrial and commercial profits no account shall be taken of the mere purchase of merchandise within the United States by the United Kingdom enterprise. The industrial or commercial profits of the permanent establishment shall be determined as if the establishment were an independent enterprise engaged in the same or similar activities and dealing at arm's length with the enterprise of which it is a permanent establishment.

§ 7.517 *Control of a domestic enterprise by a United Kingdom enterprise.* Article IV of the convention provides, in effect, that if a United Kingdom enterprise by reason of its control of a domestic enterprise imposes on such latter enterprise conditions different from those which would result from normal business relations between independent enterprises, the accounts between the enterprises may be adjusted so as to ascertain the true net income of each enterprise. The purpose is to place the controlled domestic enterprise on a tax parity with an uncontrolled domestic enterprise by determining, according to the standard of an uncontrolled enterprise, the true net income from the property and business of the controlled enterprise. The basic objective of the article is that if the accounting records do not truly reflect the net income from the property and business of such domestic enterprise the Commissioner of Internal Revenue may intervene and, by making

such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions of any item or element affecting net income as between such domestic enterprise and the United Kingdom enterprise by which it is controlled or directed, determine the true net income of the domestic enterprise. The provisions of § 29.45-1 of this chapter (Regulations 111), shall, insofar as applicable, be followed in the determination of the net income of the domestic business.

§ 7.518 *Income from operation of ships and aircraft.* The income derived from the operation of ships documented, or aircraft registered, under the laws of the United Kingdom by a nonresident alien who is a resident of the United Kingdom or by a corporation, association, or other like entity created under the laws of the United Kingdom, is, for taxable years beginning or or after January 1, 1945, exempt from United States income tax under the provisions of Article V of the convention. It is immaterial for the purpose of the exemption whether such corporation is managed and controlled in the United Kingdom.

§ 7.519 *Exemption from, or reduction in rate of, United States tax in the case of dividends, interest, royalties, natural resource royalties, and real property rentals*—(a) *Dividends, natural resource royalties, and rentals from real property*—(1) *General.* (i) The tax imposed by the Internal Revenue Code in the case of dividends, natural resource royalties, and rentals arising from real property (including leasehold and other interest in such property), received in any taxable year beginning on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom, or a foreign corporation (whether or not created under the laws of the United Kingdom) which is managed and controlled in the United Kingdom, is limited to 15 percent under the provisions of Article VI (1) (relating to dividends) and Article IX (1) (relating to natural resource royalties and rentals from real property) of the convention if such alien or corporation:

(*a*) Is subject to United Kingdom tax on such dividends, natural resource royalties and rentals, and

(*b*) At no time during the taxable year in which such dividends, natural resource royalties and rentals were so derived, was engaged in trade or business within the United States.

(ii) For the purposes of Articles VI, VII, VIII, IX and XIV of the convention, the nonresident alien or foreign corporation is not deemed to be engaged in trade or business within the United States unless such alien or foreign corporation has a permanent establishment situated therein at some time in the taxable year in which the income is derived. See Article II (2) of the convention. Thus, if a nonresident alien who is a resident of the United Kingdom, performs personal services within the United States during the calendar year 1946, has no permanent establishment within the United States at any time during such year, and is subject to United Kingdom tax upon dividends derived by him from United States sources in that year, he is entitled to the reduced rate of tax with respect to such dividends, as provided in Article VI (1) of the convention, even though by reason of his having rendered personal services within the United States he is engaged in trade or business therein in that year within the meaning of section 211 (b) of the Internal Revenue Code. If, for example, A, a nonresident alien who is a resident of the United Kingdom, derives in 1946, $5,000 compensation for such personal services and his only other income from sources within the United States consists of dividends, the dividends are subject to tax at the rate not to exceed 15 percent and his earned income is subject to normal tax and surtax without taking the dividends into account in determining the tax on such earned income.

(iii) In any case, however, in which a nonresident alien or a foreign corporation derives from sources within the United States in any taxable year beginning on or after January 1, 1945, royalties from the operation of mines, quarries, or other extraction of natural resources or rentals from real property situated within the United States and is entitled to the reduced rate of 15 percent prescribed in Article IX of the convention, such alien or foreign corporation may for such taxable year elect instead to be subject to Federal income tax as if such alien or corporation were engaged in trade or business within the United States by reason of having

a permanent establishment therein. Such election shall be made by so signifying on the return for such year. The election so signified shall be irrevocable for the taxable year for which such election is made. In such a case a return may be filed by the nonresident alien or foreign corporation even though the sole income of such alien or corporation from sources within the United States is fixed or determinable annual or periodical income upon which the tax has been fully satisfied at the source and there exists no necessity for the filing of the return except for the purposes of securing the benefits of Article IX of the convention. See § 29.217-2 of this chapter (Regulations 111).

(2) *Dividends paid by a United States subsidiary corporation.* (i) Under the proviso of Article VI (1) of the convention, dividends paid by a domestic corporation to its foreign parent corporation are subject to tax at the rate of only 5 percent if such foreign corporation controls, directly or indirectly, at the time the dividend is paid 95 percent or more of the voting power in such domestic corporation, not more than 25 percent of the gross income of the domestic corporation paying the dividend consists of dividends and interest (other than dividends and interest paid to such domestic corporation by its own subsidiary corporations, if any), and the relationship between such domestic corporation and such foreign corporation has not been arranged or maintained primarily with the intention of securing such reduced rate of 5 percent.

(ii) Thus, for example, the X Corporation is a domestic corporation, 97 percent of the entire voting stock of which is controlled by the Y Company, Ltd., a foreign corporation managed and controlled in the United Kingdom, not having a permanent establishment in the United States at any time during the calendar year 1946, and subject to United Kingdom tax with respect to any dividends received by it or credited to its account in the United States. The X Corporation makes its income tax returns on the calendar year basis and throughout each of the years 1943, 1944, and 1945 derived not more than 25 percent of its gross income from interest and dividends from corporations not controlled by it. The relationship between the X Corporation and the Y Company, Ltd., is a relationship arranged and maintained without reference to the reduced rate of tax on dividends provided in the proviso in Article VI (1) of the convention. A dividend was paid by the X Corporation to the Y Company, Ltd., on July 1, 1946. The reduced rate of tax of 5 percent is applicable to such dividend.

(b) *Interest and royalties*—(1) *General.* (i) Interest (other than interest paid by a subsidiary corporation to its United Kingdom parent corporation, as explained in subparagraph (2) of this paragraph), whether on bonds, securities, notes, debentures or any other form of indebtedness (including interest on obligations of the United States and on obligations of instrumentalities of the United States) and royalties for the privilege of using copyrights, patents, designs, secret processes and formulae, trade-marks, and other like property (including film rentals) received in any taxable year beginning on or after January 1, 1945, from sources within the United States by a nonresident alien (including a nonresident alien individual, fiduciary, and partnership) who is a resident of the United Kingdom, or a foreign corporation (whether or not organized under the laws of the United Kingdom) which is managed and controlled in the United Kingdom, are exempt from United States tax under the provisions of Articles VII and VIII of the convention if such alien, or corporation:

(*a*) Is subject to United Kingdom tax on such interest or royalty, and

(*b*) At no time during the taxable year in which such interest or royalty was so derived, had a permanent establishment situated within the United States.

(ii) Such interest and royalties are, therefore, not subject to the withholding provisions of the Internal Revenue Code.

(2) *Interest paid by subsidiary corporation to its United Kingdom parent corporation.* Article VII (1) of the convention provides in part that the exemption from United States tax of interest paid to residents of the United Kingdom shall not apply to interest paid by a domestic corporation to a foreign corporation managed and controlled in the United Kingdom if such foreign corporation controls more than 50 percent of the voting power of all classes of stock of such domestic corporation.

(c) *Beneficiaries of an estate or trust.* (1) A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust, shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Articles VI, VII, VIII, IX and XIV of the convention with respect to dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains to the extent such item or items are included in his distributive share of income of such estate or trust if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment. In such case such beneficiary must, in order to be entitled to the exemption or reduction in the rate of tax, execute Form 1001-UK or Form 1001A-UK (modified to show dividends where applicable) and file such form with the fiduciary of such estate or trust in the United States.

(2) In any case in which dividends, interest, royalties, rents or the like are derived from United States sources by a United Kingdom estate or trust any beneficiary of such estate or trust who is not a resident of the United Kingdom is not entitled to any exemption under the convention with respect to such income included in his distributive share of the income of the estate or trust.

§ 7.520 *Government wages, salaries, pensions, and similar remunerations.* Under Article X of the convention any salary, wage, similar remuneration, or pension, paid in taxable years beginning on or after January 1, 1945, by the Government of the United Kingdom for services rendered such Government (whether within or without the United States) in the discharge of its governmental functions by any individual who is not a citizen of the United States, is exempt from Federal income tax. For the purposes of the exemption an individual is treated as not a citizen of the United States if he or she has the dual status of being a citizen of the United States as well as being a subject of the United Kingdom Thus, if A, a United States citizen, marries a British subject and assumes the status of a British subject by reason of such marriage without relinquishing her United States citizenship and performs personal services in the United States for the Government of the United Kingdom, the compensation for such services is excluded from gross income. As to the taxation, generally, of compensation of alien employees of foreign governments see section 116 (h) of the Internal Revenue Code, § 29.116-2 of this chapter (Regulations 111). The exemption granted by Article X of the convention does not apply to compensation for services rendered incident to the carrying on of any trade or business by the United Kingdom.

§ 7.521 *Compensation for labor or personal services.* Article XI provides, upon a reciprocal basis, that a nonresident alien who is a resident of the United Kingdom is, for taxable years beginning on or after January 1, 1945, exempt from Federal income tax upon compensation (regardless of amount of such compensation) for personal (including professional) services performed during the taxable year within the United States if for such taxable year:

(a) Such alien is temporarily present in the United States for a period or periods not exceeding 183 days during such taxable year, and

(b) Such services are performed for or on behalf of a person resident in the United Kingdom.

As to the source of compensation for labor or personal services see section 119 (a) (3), Internal Revenue Code.

§ 7.522 *Pensions and life annuities.* Under the provisions of Article XII of the convention, pensions (other than pensions paid by the United States) and life annuities derived from sources within the United States by a nonresident alien individual who is a resident of the United Kingdom are exempt from Federal income tax for taxable years beginning on or after January 1, 1945. The term "life annuities" means a stated sum payable periodically at stated times during life or during a specified or ascertainable period of time under an obligation to make payments in consideration of payments made for such obligation.

§ 7.523 *Capital gains.* Under Article XIV of the convention, when read in association with Article II (2) of the convention, gains from the sale or exchange of capital assets by a nonresident alien individual who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom are, for taxable years beginning on or after January 1, 1945, exempt from Federal income tax unless such alien or corporation has a permanent

establishment in the United States. As to what constitutes capital assets, see section 117, Internal Revenue Code. As to what constitutes a permanent establishment see § 7.515. If A, a nonresident alien individual who is a resident of the United Kingdom, performs personal services within the United States during the calendar year 1946 for a domestic employer, he is engaged in trade or business within the United States in such taxable year. Section 211 (b), Internal Revenue Code. He carries on in that year no other business activity within the United States other than certain securities transactions upon a domestic stock exchange and maintained no office or other fixed place of business within the United States at any time during such year. A is not subject to Federal income tax upon his capital gains, if any, realized from his securities transactions. Likewise, a foreign corporation managed and controlled in the United Kingdom selling its products manufactured in the United Kingdom through a resident commission agent or broker in the United States and having certain securities transactions within the United States as its only other business activity therein is exempt from United States tax upon those capital gains, if any, arising from the securities transactions within the United States.

§ 7.524 *Dividends and interest paid by a United Kingdom corporation.* (a) A dividend paid by a foreign corporation constitutes in whole or in part income from sources within the United States and hence is subject to tax in the hands of a nonresident alien or foreign corporation, if 50 percent or more of the gross income of the foreign corporation paying such dividend is derived from sources within the United States during the period prescribed by the statute. Section 119 (a) (2) (B), Internal Revenue Code, and § 29.119-3 (b) of this chapter (Regulations 111). Interest paid by a resident foreign corporation constitutes in its entirety income from sources within the United States, and hence is subject to tax in the hands of a nonresident alien individual or foreign corporation, if 20 percent or more of the gross income of the foreign corporation paying such interest is derived from sources within the United States during the period prescribed by the statute. Section 119 (a) (1) (B), Internal Revenue Code, and § 29.119-2 (b) of this chapter (Regulations 111).

(b) Under the provisions of Article XV of the convention, dividends and interest paid by a corporation created under the laws of the United Kingdom to any nonresident alien or to any foreign corporation, whether or not such alien is a resident of the United Kingdom and whether or not such foreign corporation is organized under the laws of the United Kingdom, are, for taxable years beginning on or after January 1, 1945, not subject to Federal income tax regardless of whether the corporation paying such dividends or interest is a resident foreign (as to the United States) corporation and regardless of the percentage of its gross income derived from sources within the United States.

§ 7.525 *United Kingdom corporations; exemption from Federal taxation with respect to accumulated profits or undistributed income.* (a) Section 102 of the Internal Revenue Code imposes (in addition to other taxes imposed by Chapter 1 of such Code) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. Such tax, however, does not apply in the case of personal holding companies as defined in section 501 of the Internal Revenue Code nor to foreign personal holding companies as defined in Supplement P (section 331) of such Code. Section 500 of the Internal Revenue Code imposes (in addition to the taxes imposed by Chapter 1 of such code) a graduated income tax or surtax upon corporations classified as personal holding companies, regardless of whether or not they are formed or availed of to accumulate earnings or profits for the purpose of avoiding surtax upon shareholders.

(b) Under the provisions of Article XVI of the convention corporations organized under the laws of the United Kingdom are, for taxable years beginning on or after January 1, 1945, subject to neither the tax imposed by section 102 of the Internal Revenue Code nor the tax imposed by section 500 of such code if more than 50 percent of the entire voting power in such corporation is controlled directly or indirectly throughout the last half of the taxable year by nonresident alien individuals who are residents of

the United Kingdom. To come within the scope of the exemption, the prescribed proportion of the stock of the United Kingdom corporation concerned must be so owned at all times throughout the last half of the taxable year in which the taxable status of the corporation is involved. In determining the ownership of the voting stock of the United Kingdom corporation, the provisions of §§ 29.503 (a)-1 to 29.503 (a)-7 and § 29.503 (b)-1 of this chapter (Regulations 111), shall, in so far as not inconsistent with the convention, be applicable in the administration of the provisions of the convention.

§ 7.526 *Visiting professors or teachers.* Under Article XVIII of the convention, an alien individual who is from the territory of the United Kingdom, but who is temporarily present within the United States for the purposes of teaching, lecturing, or instructing, at any university, college, school, or other educational institution situated within the United States, is, for a period not exceeding two years from the date of his arrival in the United States, exempt for taxable years beginning on or after January 1, 1945, from Federal income tax on remuneration received for such services. It shall be deemed that such alien coming to the United States for the purposes indicated has, for a period of not more than two years immediately succeeding the date of his arrival within the United States for such purposes, the tax status of a nonresident alien in the absence of proof of his intention to remain indefinitely in the United States.

§ 7.527 *Remittances.* Under Article XIX of the convention nonresident alien individuals who are from the territory of the United Kingdom but who are temporarily present in the United States for the purposes of study or for acquiring business experience or training are exempt, for taxable years beginning on or after January 1, 1945, from Federal income tax upon amounts representing remittances from sources within the United Kingdom for the purposes of their maintenance, education, and training.

§ 7.528 *Credit against United States tax liability for income tax paid or deemed to have been paid to the United Kingdom.* (a) For the purpose of avoidance of double taxation, Article XIII of the convention provides that there shall be allowed on the part of the United States, in accordance with section 131 of the International Revenue Code as in effect on the first day of January 1945, for taxable years beginning on or after January 1, 1945, against the United States income and excess profits tax liability a credit for United Kingdom taxes.

(b) In determining the credit under section 131 of the Internal Revenue Code, in any case in which a taxpayer receives a dividend from a foreign corporation managed and controlled in the United Kingdom it shall be deemed that such taxpayer has paid to the United Kingdom, the United Kingdom income tax at the rate appropriate to such dividend, if such taxpayer elects to include in his gross income an amount equivalent to such United Kingdom income tax in addition to the amount of the dividend otherwise included in gross income.

(c) Thus, if such foreign corporation declares during the taxable year 1945 a gross dividend of which the taxpayer's share is $1,000, and the standard rate of United Kingdom income tax in 1945 is 50 percent and such corporation is not entitled to any "relief" from the payment of the standard rate of tax because of any Dominion income tax paid by it, there is deducted at the source of such corporation incident to the payment of the dividend of $1,000 the sum of $500, leaving a net amount of $500 actually received by the taxpayer. If the taxpayer elects to include the entire amount of $1,000 in his gross income, the amount of $500, representing the United Kingdom income tax deemed to have been paid, is allowable as a credit under section 131 of the Internal Revenue Code, subject to the limitations provided in that section. If, however, the foreign corporation is entitled to "relief" for Dominion income tax paid by it so that the amount of tax deducted from the gross dividend is the net United Kingdom income tax (representing the standard tax reduced by the relief for Dominion income tax) the amount of such net United Kingdom tax is the amount allowable as a credit against the United States income tax under the provisions of section 131 of the Internal Revenue Code, subject to the limitations provided in that section provided the taxpayer elects to include in his gross income, in addition to the amount of the dividend received by him, the net United Kingdom tax appropriate to the dividend.

See §§ 29.131-1 to 29.131-8 of this chapter (Regulations 111).

(d) The net United Kingdom tax is also the basis of the credit in the case of a dividend paid by such corporation subsequent to 1945 even though the tax required to be deducted from such dividend must be determined without taking into account any reduction by reason of "relief" from double taxation to which the corporation paying such dividend may be entitled. Thus, for example, a foreign corporation managed and controlled in the United Kingdom derives all of its income from sources within a British Dominion which imposes an income tax at an effective rate of 20 percent. On July 1, 1946, it pays a dividend, the gross amount of which in the case of A, a United States citizen shareholder resident in the United States, is $1,000. The amount of tax required to be withheld by the corporation is $450 or a rate of 45 percent applied to the gross amount of the dividend and A receives a net dividend of $550. However, the corporation in the payment of its United Kingdom income tax received a credit against the rate of 45 percent for the 20 percent tax paid to the Dominion. Hence the net United Kingdom rate is 25 percent which, applied to the gross dividend of $1,000, equals $250 which constitutes the United Kingdom income tax appropriate to the dividend. In such case, if A elects to take a credit for the United Kingdom tax appropriate to the dividend, he must include in gross income the amount of $550 plus $250, or $800, the sum of $250 being the basis of the resulting credit under the provisions of section 131, Internal Revenue Code.

(e) Assume that a domestic corporation owns stock in a foreign corporation managed and controlled in the United Kingdom (referred to in this subpart as the first United Kingdom corporation), that the first United Kingdom corporation has as its sole income dividends received from a second United Kingdom corporation and that such second United Kingdom corporation derives all its income from sources within the X British Colony which imposes upon such second United Kingdom corporation tax at the rate of 20 percent of its income. Both the first and second United Kingdom corporations are subject to tax imposed by the United Kingdom. However, in the imposition of such tax upon the second United Kingdom corporation, there is allowed under United Kingdom law against the United Kingdom standard tax of 45 percent a credit of 20 percent imposed by the X Colony and hence such corporation pays United Kingdom tax at the rate of 25 percent. The second United Kingdom corporation is deemed under United Kingdom law to have paid the 25 percent United Kingdom tax with respect to the dividends paid by it and, in turn, the first United Kingdom corporation is deemed to have paid United Kingdom tax of 25 percent with respect to such dividends. When, therefore, dividends are received by the domestic corporation from the first United Kingdom corporation, such domestic corporation will for the purposes of the credit under section 131 be deemed to have paid United Kingdom tax of 25 percent. Such domestic corporation may elect to include in its gross income the amount of United Kingdom tax thus deemed to have been paid and to claim credit for such tax under the provisions of section 131 of the Internal Revenue Code.

§ 7.529 *Adjustment of tax liability of nonresident aliens who are residents of the United Kingdom and of United Kingdom corporations.* (a) Article XVII (1) of the convention confers upon the Commissioner of Internal Revenue authority to adjust the tax liability for taxable years beginning prior to January 1, 1936, of any nonresident alien individual who is a resident of the United Kingdom and of any corporation organized under the laws of the United Kingdom (whether or not such corporation is managed and controlled in the United Kingdom) in any case in which such tax liability remained unpaid on April 16, 1945 (the date of signature of the convention). Such provisions, however, will not apply unless:

(1) The taxpayer files with the Commissioner of Internal Revenue on or before December 31, 1947, a request that such tax liability be so adjusted and a sworn statement showing for each year involved and for such other years as the Commissioner of Internal Revenue may require, (i) by items and classes of income the amounts of dividends, interest, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical income, gains, profits, and income derived from sources within the United States; (ii) the business transactions, if any, carried on in the United States by or in behalf of the taxpayer during each of such years; and

(iii) such further information as the Commissioner of Internal Revenue may require in the particular case; and

(2) The Commissioner of Internal Revenue is satisfied that the additional income tax involved did not arise by reason of fraud with intent to evade the tax on the part of the taxpayer concerned.

(b) In any case in which the Commissioner of Internal Revenue deems it appropriate to exercise the authority thus conferred, the resulting tax liability for any such year or years may not exceed the amount of the liability which would be determined had the following been given effect for such year or years:

(1) The Revenue Act of 1936 (but this does not apply in the case of a United Kingdom corporation in which more than 50 percent of the entire voting power was controlled, directly or indirectly, through the latter half of the taxable year for which the liability is being determined by citizens or residents of the United States);

(2) Article XV of the convention, exempting from United States tax dividends and interest paid by a United Kingdom corporation to nonresident aliens or foreign corporations; and

(3) Article XVI of the convention, exempting United Kingdom corporations from the tax imposed by the United States with respect to accumulated or undistributed earnings, profits, income, or surplus.

(c) In any case in which the Commissioner of Internal Revenue has exercised his authority to apply the provisions of Article XVII (1) of the convention, if the taxpayer was not engaged in trade or business within the United States and had no office or place of business therein during the taxable year involved, the aggregate amount of interest and penalties may not exceed 50 percent of the amount of the tax with respect to which such interest and penalties have been computed.

(d) Article XVII (2) of the convention provides that the Federal income tax liability for taxable years beginning after December 31, 1935, and prior to January 1, 1945, which remains unpaid on April 16, 1945, the date of signature of the convention, in the case of any nonresident alien individual, a resident of the United Kingdom, or of any United Kingdom corporation, shall be determined under the United States internal revenue law properly applicable thereto, except that Articles XV (relating to exemption from United States tax of dividends and interests paid by a United Kingdom corporation) and XVI (relating to exemption of a United Kingdom corporation from United States tax with respect to accumulated earnings or profits) of the convention shall be treated as being in effect for such years. (See §§ 7.524 and 7.525.)

§ 7.530 *Reciprocal administrative assistance.* (a) By Article XX of the convention, the United States and the United Kingdom adopt the principle of exchange of such information as is necessary to the administration of the provisions of the convention or for the prevention of fraud or for the detection of practices which are aimed at reduction of the revenues of either Contracting Party but not including information which would disclose any trade secret or trade process. Pursuant to such principle, every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042D, in addition to the withholding return, Form 1042, for the calendar year 1946 and each subsequent calendar year, with respect to: (1) Dividends from which a tax of 15 percent was withheld from persons whose addresses are in the United Kingdom (5 percent in the case of dividends falling within the scope of the proviso of Article VI (1) of the convention); (2) real property rentals and natural resource royalties from which a tax of 15 percent was withheld from persons whose addresses are in the United Kingdom; (3) royalties and like amounts and interest from which no tax was withheld from persons whose addresses are in the United Kingdom; and (4) all other fixed or determinable annual or periodical income paid to persons whose addresses are in the United Kingdom.

(b) The information and correspondence relative to exchange of information may be transmitted directly by the Commissioner of Internal Revenue to the Commissioners of Inland Revenue.

§ 7.531 *Information to be furnished in due course.* In accordance with the provisions of Article XX of the convention the Commissioner of Internal Revenue will forward to the Commissioners of Inland Revenue as soon as practicable after the close of the calendar year 1946, and of each calendar year thereafter during which the convention is in effect,

the names and addresses of all persons whose addresses are within the United Kingdom and who derived from sources within the United States dividends, interest, rents, royalties, salaries, wages, pensions, annuities, or other fixed or determinable annual or periodical profits and income, showing the amounts of such items of income in the case of each addressee. For these purposes the transmission to the Commissioners of Inland Revenue of information return Form 1042D as provided in § 7.530 for the calendar year 1946, and subsequent calendar years, shall constitute compliance with the provisions of Article XX of the convention and of §§ 7.512 to 7.532.

§ 7.532 *Information in specific cases.* Under the provisions of Article XX of the convention and upon request of the Commissioners of Inland Revenue, the Commissioner of Internal Revenue shall furnish to the Commissioners of Inland Revenue any information (other than information that would disclose any trade secret or trade process) available to or obtainable by the Commissioner of Internal Revenue relative to the tax liability of any person under the revenue laws of the United Kingdom in any case in which such information is necessary to the administration of the provisions of the convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance.

Part 16—Excess Profits on Army Contracts for Aircraft

REGULATIONS UNDER SECTION 14 OF THE ACT OF APRIL 3, 1939, AND OTHER PROVISIONS

Sec.
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AUTHORITY: §§ 16.1 to 16.18 issued under 52 Stat. 467; 26 U. S. C. 3791. Interpret or apply sec. 3, 48 Stat. 505, as amended, sec. 14, 53 Stat. 560; 34 U. S. C. 496, 10 U. S. C. 311, 312.

SOURCE: §§ 16.1 to 16.18 contained in Treasury Decision 4909, 4 F. R. 2733.

§ 16.1 *Definitions.* As used in the regulations in this part the term:

(a) "Act" means the act of April 3, 1939 (53 Stat. 560; 10 U. S. C. 311, 312, 34 U. S. C. 496), together with the applicable provisions of section 3 of the act of March 27, 1934, 48 Stat. 505; 34 U. S. C. 496, as amended by the act of June 25, 1936, 49 Stat. 1926; 34 U. S. C., Sup. IV, 496, and as further amended by the act of April 3, 1939 (53 Stat. 560; 34 U. S. C. 496).

(b) "Person" includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation or venture is carried on.

(c) "Contract" means an agreement made by authority of the Secretary of the Army for the construction or manufacture of any complete aircraft or any portion thereof for the Army.

(d) "Contractor" means a person entering into a direct contract with the Secretary of the Army or his duly authorized representative.

(e) "Subcontract" means an agreement entered into by one person with another person for the construction or manufacture of any complete aircraft or any portion thereof for the Army, the prime contract for such aircraft or portion thereof having been entered into between a contractor and the Secretary of the Army or his duly authorized representative.

(f) "Subcontractor" means any person other than a contractor entering into a subcontract.

(g) "Contracting party" means a contractor or subcontractor as the case may be.

(h) "Contract price" or "total contract price" means the amount or total

amount to be received under a contract or subcontract as the case may be.

(i) "Income-taxable year" means the calendar year, the fiscal year ending during such calendar year, or the fractional part of such calendar or fiscal year, upon the basis of which the contracting party's net income is computed and for which its income tax returns are made for Federal income tax purposes.

§ 16.2 *Contracts and subcontracts under which excess profit liability may be incurred.* Except as otherwise provided with respect to contracts or subcontracts for certain scientific equipment (see § 16.3), every contract awarded for an amount exceeding $10,000 and entered into after the enactment of the act of April 3, 1939 for the construction or manufacture of any complete aircraft or any portion thereof for the Army, is subject to the provisions of the act relating to excess profit liability. Any subcontract made with respect to such a contract and involving an amount in excess of $10,000 is also within the scope of the act. If a contracting party places orders with another party, aggregating an amount in excess of $10,000, for articles or materials which constitute a part of the cost of performing the contract or subcontract, the placing of such orders shall constitute a subcontract within the scope of the act, unless it is clearly shown that each of the orders involving $10,000 or less is a bona fide separate and distinct subcontract and not a subdivision made for the purpose of evading the provisions of the act.

§ 16.3 *Contracts or subcontracts for scientific equipment.* No excess profit liability is incurred upon a contract or subcontract entered into after the enactment of the act of April 3, 1939, if at the time or prior to the time such contract or subcontract is made it is designated by the Secretary of the Army as being exempt under the provisions of the act pertaining to scientific equipment used for communication, target detection, navigation, and fire control.

§ 16.4 *Completion of contract defined.* The date of delivery of the aircraft or portion thereof covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of the Army and the Secretary of the Treasury or their duly authorized representatives. Except as otherwise provided in the preceding sentence, the replacement of defective parts or delivered articles or the performance of other guarantee work in respect of such articles will not operate to extend the date of completion. As to the treatment of the cost of such work as a cost of performing a contract or subcontract, see § 16.8 (h). As to a refund in case of adjustment due to any subsequently incurred additional costs, see § 16.18. If a contract or subcontract is at any time cancelled or terminated, it is completed at the time of the cancellation or termination.

§ 16.5 *Manner of determining liability.* (a) The first step in the determination of the excess profit to be paid to the United States by a contracting party with respect to contracts and subcontracts completed within an income-taxable year is to ascertain the total contract prices of all contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see § 16.7.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step. See § 16.8. The amount remaining after such subtraction is the amount of net profit or net loss upon the contracts and subcontracts completed within the income-taxable year.

(c) The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 12 percent of the total contract prices of the contracts and subcontracts completed within the income-taxable year;

(2) The amount of any net loss sustained in a prior income-taxable year and allowable as a credit in determining the excess profit for the income-taxable year (see § 16.9); and

(3) The amount of any deficiency in profit sustained in a prior income-taxable year and allowable as a credit in determining the excess profit for the income-taxable year (see § 16.9). The amount remaining after such subtraction is the amount of excess profit for the income-taxable year.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit (see § 16.10) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year.

§ 16.6 *Computation of excess profit liability.* The application of the provisions of § 16.5 may be illustrated by the following example:

Example: On September 1, 1939, the B Corporation which keeps its books and makes its Federal income tax returns on a calendar year basis entered into a contract coming within the scope of the act, the total contract price of which was $200,000. On March 10, 1940, the corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost $45,000. During the year 1939 the B Corporation sustained a net loss of $2,500 and a deficiency in profit of $1,000 on contracts and subcontracts entered into after April 3, 1939, and completed within the income-taxable year 1939. For purposes of the Federal income tax, the net income of the B Corporation for the year 1940 amounted to $96,000, which included the total net profit of $40,000 upon the two contracts. For the year 1940 the B Corporation paid a Federal income tax of $13,240 upon its entire net income. The excess profit liability is $6,700 computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less: Cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less: 12 percent of total contract prices (12 percent of $240,000)	$28,800	
Net loss from 1939	2,500	
Deficiency in profit from 1939	1,000	
		32,300
Excess profit for year 1940		7,700
Less: Credit for Federal income taxes (Federal income tax on $7,700 at the rates for 1940)		1,000
Amount of excess profit payable to the United States		6,700

§ 16.7 *Total contract price.* The total contract price of a particular contract or subcontract (see § 16.1) may be received in money or its equivalent. If something other than money is received, only the fair market value of the thing received, at the date of receipt, is to be included in determining the amount received. Bonuses earned for bettering performance and penalties incurred for failure to meet the contract guarantees are to be regarded as adjustments of the original contract price. Trade or other discounts granted by a contracting party in respect of a contract or subcontract performed by such party are also to be deducted in determining the true total contract price of such contract or subcontract.

§ 16.8 *Cost of performing a contract or subcontract*—(a) *General rule.* The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs, including therein expenditures for materials, direct labor and direct expenses, incurred by the contracting party in performing the contract or subcontract; and (2) the proper proportion of any indirect costs (including therein a reasonable proportion of management expenses) incident to and necessary for the performance of the contract or subcontract.

(b) *Elements of cost.* No definitions of the elements of cost may be stated which are of invariable application to all contractors and subcontractors. In general, the elements of cost may be defined for purposes of the act as follows:

(1) Manufacturing cost, which is the sum of factory cost (see paragraph (c) of this section) and other manufacturing cost (see paragraph (d) of this section);

(2) Miscellaneous direct expenses (see paragraph (e) of this section);

(3) General expenses, which are the sum of indirect engineering expenses, usually termed "engineering overhead" (see paragraph (f) of this section) and expenses of distribution, servicing and administration (see paragraph (g) of this section); and

(4) Guarantee expenses (see paragraph (h) of this section).

(c) *Factory cost.* Factory cost is the sum of the following:

(1) *Direct materials.* Materials, such as those purchased for stock and subsequently issued for contract operations and those acquired under subcontracts,

which become a component part of the finished product or which are used directly in fabricating, converting or processing such materials or parts.

(2) *Direct productive labor.* Productive labor, usually termed "shop labor," which is performed on and is properly chargeable directly to the article manufactured or constructed pursuant to the contract or subcontract, but which ordinarily does not include direct engineering labor (see subparagraph (3) of this paragraph).

(3) *Direct engineering labor.* The compensation of professional engineers and other technicists (including reasonable advisory fees), and of draftsmen, properly chargeable directly to the cost of the contract or subcontract.

(4) *Miscellaneous direct factory charges.* Items which are properly chargeable directly to the factory cost of performing the contract or subcontract but which do not come within the classifications in subparagraphs (1), (2), and (3) of this paragraph, as for example, royalties which the contracting party pays to another party and which are properly chargeable to the cost of performing the contract or subcontract (but see paragraph (d) of this section).

(5) *Indirect factory expenses.* Items, usually termed "factory overhead," which are not directly chargeable to the factory cost of performing the contract or subcontract but which are properly incident to and necessary for the performance of the contract or subcontract and consist of the following:

(i) *Labor.* Amounts expended for factory labor, such as supervision and inspection, clerical labor, timekeeping, packing and shipping, stores supply, services of tool crib attendants, and services in the factory employment bureau, which are not chargeable directly to productive labor of the contract or subcontract.

(ii) *Materials and supplies.* The cost of materials and supplies for general use in the factory in current operations, such as shop fuel, lubricants, heat-treating, plating, cleaning and anodizing supplies, nondurable tools and gauges, stationery (such as time tickets and other forms), and boxing and wrapping materials.

(iii) *Service expenses.* Factory expenses of a general nature, such as those for power, heat and light (whether purchased or produced), ventilation and air-conditioning and operation and maintenance of general plant assets and facilities.

(iv) *Fixed charges and obsolescenee.* Recurring charges with respect to property used for manufacturing purposes of the contract or subcontract, such as premiums for fire and elevator insurance, property taxes, rentals and allowances for depreciation of such property, including maintenance and depreciation of reasonable stand-by equipment; and depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract. In making allowances for depreciation, consideration shall be given to the number and length of shifts.

(v) *Miscellaneous indirect factory expenses.* Miscellaneous factory expenses not directly chargeable to the factory cost of performing the contract or subcontract, such as purchasing expenses; ordinary and necessary expenses of rearranging facilities within a department or plant; employees' welfare expenses; premiums or dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to factory employees; factory accident compensation (as to self-insurance, see paragraph (g) of this section); but not including any amounts which are not incident to services, operations, plant, equipment or facilities involved in the performance of the contract or subcontract.

(d) *Other manufacturing cost.* Other manufacturing cost as used in paragraph (b) of this section includes items of manufacturing costs which are not properly or satisfactorily chargeable to factory costs (see paragraph (c) of this section) but which upon a complete showing of all pertinent facts are properly to be included as a cost of performing the contract or subcontract, as for instance, payments of royalties and amortization of the cost of designs purchased and patent rights over their useful life; and "deferred" or "unliquidated" experimental and development charges. For example, in case experimental and development costs have been properly deferred or capitalized and are amortized in accordance with a reasonably consistent plan, a proper portion

of the current charge, determined by a ratable allocation which is reasonable in consideration of the pertinent facts, may be treated as a cost of performing the contract or subcontract. In the case of general experimental and development expenses which may be charged off currently, a reasonable portion thereof may be allocated to the cost of performing the contract or subcontract. If a special experimental or development project is carried on in pursuance of a contract, or in anticipation of a contract which is later entered into, and the expense is not treated as a part of general experimental and development expenses or is not otherwise allowed as a cost of performing the contract, there clearly appearing no reasonable prospect of an additional contract for the type of article involved, the entire cost of such project may be allowed as a part of the cost of performing the contract.

(e) *Miscellaneous direct expenses.* Miscellaneous direct expenses as used in paragraph (b) of this section include:

(1) *Cost of installation and construction.* Cost of installation and construction includes the cost of materials, labor and expenses necessary for the erection and installation prior to the completion of the contract and after the delivery of the product or material manufactured or constructed pursuant to the contract or subcontract.

(2) *Sundry direct expenses.* Items of expense which are properly chargeable directly to the cost of performing a contract or subcontract and which do not constitute guarantee expenses (see paragraph (h) of this section) or direct costs classified as factory cost or other manufacturing cost (see paragraphs (c) and (d) of this section), such as premiums on performance or other bonds required under the contract or subcontract; State sales taxes imposed on the contracting party; freight on outgoing shipments; fees paid for wind tunnel and model basin tests; demonstration and test expenses; crash insurance premiums; traveling expenses. In order for any such item to be allowed as a charge directly to the cost of performing a contract or subcontract, (i) a detailed record shall be kept by the contracting party of all items of a similar character, and (ii) no item of a similar character which is properly a direct charge to other work shall be allowed as a part of any indirect expenses in determining the proper proportion thereof chargeable to the cost of performing the contract or subcontract. As to allowable indirect expenses, see paragraphs (c) (5), (f), (g) and (j) of this section.

(f) *Indirect engineering expenses.* Indirect engineering expenses, usually termed "engineering overhead," which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprise the general engineering expenses which are incident to and necessary for the performance of the contract or subcontract, such as the following:

(1) *Labor.* Reasonable fees of engineers employed in a general consulting capacity, and compensation of employees for personal services to the engineering department, such as supervision, which is properly chargeable to the contract or subcontract, but which is not chargeable as direct engineering labor (see paragraph (c) (3) of this section).

(2) *Material.* Supplies for the engineering department, such as paper and ink for drafting and similar supplies.

(3) *Miscellaneous expenses.* Expenses of the engineering department, such as (i) maintenance and repair of engineering equipment, and (ii) services purchased outside of the engineering department for blue printing, drawing, computing, and like purposes.

(g) *Expenses of distribution, servicing and administration.* Expenses of distribution, servicing and administration, which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprehend the expenses incident to and necessary for the performance of the contract or subcontract, which are incurred in connection with the distribution and general servicing of the contracting party's products and the general administration of the business, such as:

(1) *Compensation for personal services of employees.* The salaries of the corporate and general executive officers and the salaries and wages of administrative clerical employees and of the office services employees such as telephone operators, janitors, cleaners, watchmen and office equipment repairmen.

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(2) *Bidding and general selling expenses.* Bidding and general selling expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract. The treatment of bidding and general selling expenses as a part of general expenses in accordance with this paragraph is in lieu of any direct charges which otherwise might be made for such expenses. The term "bidding expenses" as used in this section includes all expenses in connection with preparing and submitting bids.

(3) *General servicing expenses.* Expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract and which are incident to delivered or installed articles and are due to ordinary adjustments or minor defects; but including no items which are treated as a part of guarantee expenses (see paragraph (h) of this section) or as a part of direct costs, such as direct materials, direct labor, and other direct expense.

(4) *Other expenses.* Miscellaneous office and administrative expenses, such as stationery and office supplies; postage; repair and depreciation of office equipment; contributions to local charitable or community organizations to the extent constituting ordinary and necessary business expenses; employees' welfare expenses; premiums and dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to administrative office employees and accident compensation to office employees (as to self-insurance, see subdivision (i) of this subparagraph.

(i) Subject to the exception stated in this subdivision, in cases where a contracting party assumes its own insurable risks (usually termed "self-insurance"), losses and payments will be allowed in the cost of performing a contract or subcontract only to the extent of the actual losses suffered or payments incurred during, and in the course of, the performance of the contract or subcontract and properly chargeable to such contract or subcontract. If, however, a contracting party assumes its own insurable risks (a) for compensation paid to employees for injuries received in the performance of their duties, or (b) for unemployment risks in States where insurance is required, there may be allowed as a part of the cost of performing a contract or subcontract a reasonable portion of the charges set up for purposes of self-insurance under a system of accounting regularly employed by the contracting party, as determined by the Commissioner of Internal Revenue, at rates not exceeding the lawful or approved rates of insurance companies for such insurance, reduced by amounts representing the acquisition cost in such companies, provided the contracting party adopts and consistently follows this method with respect to self-insurance in connection with all contracts and subcontracts subsequently performed by him.

(ii) Allowances for interest on invested capital are not allowable as costs of performing a contract or subcontract.

(iii) Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: Entertainment expenses; dues and memberships other than of regular trade associations; donations except as otherwise provided above; losses on other contracts; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; amortization of unrealized appreciation of values of assets; expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacated or abandoned, or not adaptable for future use in performing contracts or subcontracts; increases in reserve accounts for contingencies, repairs, compensation insurance (except as above provided with respect to self-insurance) and guarantee work; Federal and State income and excess-profits taxes and surtaxes; cash discount earned up to one percent of the amount of the purchase, except that all discounts on subcontracts subject to the act will be considered; interest incurred or earned; bond discount or finance charges; premiums for life insurance on the lives of officers; legal and accounting fees in connection with reorganizations, security issues, capital stock issues and the prosecution of claims against the United

States (including income tax matters); taxes and expenses on issues and transfers of capital stock; losses on investments; bad debts; and expenses of collection and exchange.

(iv) In order that the cost of performing a contract or subcontract may be accounted for clearly, the amount of any excess profits repayable to the United States pursuant to the act should not be charged to or included in such cost.

(h) *Guarantee expenses.* Guarantee expenses include the various items of factory cost, other manufacturing cost, cost of installation and construction, indirect engineering expenses and other general expenses (see paragraphs (c) to (g), of this section) which are incurred after delivery or installation of the article manufactured or constructed pursuant to the particular contract or subcontract and which are incident to the correction of defects or deficiencies which the contracting party is required to make under the guarantee provisions of the particular contract or subcontract. If the total amount of such guarantee expenses is not ascertainable at the time of filing the report required to be filed with the collector of internal revenue (see § 16.15) and the contracting party includes any estimated amount of such expenses as part of the claimed total cost of performing the contract or subcontract, such estimated amount shall be separately shown on the report and the reasons for claiming such estimated amount shall accompany the report; but only the amount of guarantee expenses actually incurred will be allowed. If the amount of guarantee expenses actually incurred is greater than the amount (if any) claimed on the report and the contracting party has made an overpayment of excess profit, a refund of the overpayment shall be made in accordance with the provisions of § 16.18. If the amount of guarantee expenses actually incurred is less than the amount claimed on the report and an additional amount of excess profit is determined to be due, the additional amount of excess profit shall be assessed and paid in accordance with the provisions of § 16.18.

(i) *Unreasonable compensation.* (1) The salaries and compensation for services which are treated as a part of the cost of performing a contract or subcontract include reasonable payments for salaries, bonuses, or other compensation for services. As a general rule, bonuses paid to employees (and not to officers) in pursuance of a regularly established incentive bonus system may be allowed as a part of the cost of performing a contract or subcontract.

(2) The test of allowability is whether the aggregate compensation paid to each individual is for services actually rendered incident to, and necessary for, the performance of the contract or subcontract, and is reasonable. Excessive or unreasonable payments, whether in cash, stock or other property ostensibly as compensation for services shall not be included in the cost of performing a contract or subcontract.

(j) *Allocation of indirect costs.* No general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract. Subject to a requirement that all items which have no relation to the performance of the contract or subcontract shall be eliminated from the amount to be allocated, the following methods of allocation are outlined as acceptable in a majority of cases:

(1) *Factory indirect expenses.* The allowable indirect factory expenses (see paragraph (c) (5) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct productive labor (see paragraph (c) (2) of this section) attributable to the contract or subcontract bears to the total direct productive labor of the production department or particular section thereof during the period within which the contract or subcontract is performed, except that if the indirect factory expenses are incurred in different amounts and in different proportions by the various producing departments consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination of the true profit and excess profit.

(2) *Engineering indirect expenses.* The allowable indirect engineering expenses (see paragraph (f) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct engineering

labor attributable to the contract or subcontract (see paragraph (c) (3) of this section) bears to the total direct engineering labor of the engineering department or particular section thereof during the period within which the contract or subcontract is performed. If the expenses of the engineering department are not sufficient in amount to require the maintenance of separate accounts, the engineering indirect costs may be included in the indirect factory expenses (see paragraph (c) (5) of this section) and allocated or distributed to the cost of performing the contract or subcontract as a part of such expenses, provided the proportion so allocated or distributed is proper under the facts and circumstances relating to the performance of the particular contract or subcontract.

(3) *Administrative expenses (or "overhead")*. The allowable expenses of administration (see paragraph (g) of this section) or other general expenses except indirect engineering expenses, bidding and general selling expenses, and general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of the proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

(4) *Bidding, general selling, and general servicing expenses.* The allowable bidding and general selling expenses and general servicing expenses (see paragraph (g) (2) and (3) of this section) shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of:

(i) The proportion which the contract price of the particular contract or subcontract bears to the total sales made (including contracts or subcontracts completed) during the period within which the particular contract or subcontracts is performed, or

(ii) The proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed,

except that special consideration shall be given to the relation which certain classes of such expenses bear to the various classes of articles produced by the contracting party in each case in which such consideration is necessary in order to make a fair and reasonable determination of the true profit and excess profit. See § 16.13.

§ 16.9 *Credit for net loss or for deficiency in profit in computing excess profit.* (a) The term "net loss" as used in the act and as applied to contracts and subcontracts coming within the regulations in this part means the amount by which the total costs of performing all such contracts and subcontracts entered into after April 3, 1939 and completed by a particular contracting party within the income-taxable year exceeds the total contract prices of such contracts and subcontracts. As to the meaning of income-taxable year, see § 16.1.

(b) The term "deficiency in profit" as used in the act and as applied to contracts and subcontracts coming within the regulations in this part means the amount by which 12 percent of the total contract prices of all such contracts and subcontracts entered into after April 3, 1939 and completed by a particular contracting party within the income-taxable year exceeds the net profit upon all such contracts and subcontracts.

(c) A net loss or a deficiency in profit sustained by a contracting party for an income-taxable year is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts coming within the regulations in this part and completed during the four next succeeding income-taxable years. Credit for such a net loss or deficiency in profit may be claimed in the contracting party's annual report of profit filed with the collector of internal revenue (see § 16.15), but it shall be supported by separate schedules for each contract or subcontract involved showing total contract prices, costs of performance and pertinent facts relative thereto, together with a summarized computation of the net loss or deficiency in profit. The net loss or deficiency in profit claimed is subject to verification

and adjustment. As to preservation of books and records, see § 16.13.

(d) Net loss or deficiency in profit sustained on contracts and subcontracts completed within one income-taxable year may not be considered in computing net loss or deficiency in profit sustained on contracts and subcontracts completed within another income-taxable year.

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

Example: The A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into and completed contracts for aircraft for the Army coming within the scope of the act as follows: Contracts were completed within the calendar year 1939 on which the A Corporation sustained a net loss of $30,000 and a deficiency in profit of $10,000; contracts totaling $175,000 were completed in 1940 at a cost of $155,000, the A Corporation thereby realizing a net profit of $20,000 but sustaining a deficiency in profit of $1,000 (i. e., 12 percent of $175,000, or $21,000, less $20,000); contracts totaling $400,000 were completed in 1941 at a cost of $300,000, or at a net profit of $100,000. After deducting from the net profit of $100,000 for the year 1941 the amount of $48,000 (i. e., 12 percent of the total contract prices of $400,000), there remains $52,000 in excess profit on the contracts completed in the year 1941. The net loss of $30,000 and the deficiency in profit of $10,000 sustained in 1939 and the deficiency in profit of $1,000 sustained in 1940 may be deducted from such $52,000 in determining the amount of excess profit payable by the A Corporation for the year 1941 with respect to the contracts completed in such year.

§ 16.10 *Credit for Federal income taxes.* For the purpose of computing the amount of excess profit to be paid to the United States, a credit is allowable against the excess profit for the amount of Federal income taxes paid or remaining to be paid on the amount of such excess profit. The "Federal income taxes" in respect of which this credit is allowable include the income taxes imposed by Titles I and IA of the Revenue Act of 1938, and chapter 1 and subchapter A of chapter 2 of the Internal Revenue Code, and the excess-profits taxes imposed by section 602 of the Revenue Act of 1938 and subchapter B of chapter 2 of the Internal Revenue Code. This credit is allowable for these taxes only to the extent that it is affirmatively shown that they have been finally determined and paid or remain to be paid and that they were imposed upon the excess profit against which the credit is to be made. In case such a credit has been allowed and the amount of Federal income taxes imposed upon the excess profit is redetermined, the credit previously allowed shall be adjusted accordingly.

§ 16.11 *Failure of contractor to require agreement by subcontractor.* (a) Every contract or subcontract coming within the scope of the act and the regulations in this part is required by the act to contain, among other things, an agreement by the contracting party to make no subcontract unless the subcontractor agrees:

(1) To make a report, as described in the act, under oath to the Secretary of War upon the completion of the subcontract;

(2) To pay into the Treasury excess profit, as determined by the Treasury Department, in the manner and amounts specified in the act;

(3) To make no subdivision of the subcontract for the same article or articles for the purpose of evading the provisions of the act;

(4) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and audit as provided in the act.

(b) If a contracting party enters into a subcontract with a subcontractor who fails to make such agreement, such contracting party shall, in addition to its liability for excess profit determined on contracts or subcontracts performed by it, be liable for any excess profit determined to be due the United States on the subcontract entered into with such subcontractor. In such event, however, the excess profit to be paid to the United States in respect of the subcontract entered into with such subcontractor shall be determined separately from any contracts or subcontracts performed by the contracting party entering into the subcontract with such subcontractor.

§ 16.12 *Evasion of excess profit.* Section 3 of the act of March 27, 1934, as amended, provides that the contracting party shall agree to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of the act. If any such subdivision or subcontract is made it shall constitute a violation of the agreement provided for in the

act, and the cost of completing a contract or subcontract by a contracting party which violates such agreement shall be determined in a manner necessary clearly to reflect the true excess profit of such contracting party.

§ 16.13 *Books of account and records.* (a) It is recognized that no uniform method of accounting can be prescribed for all contracting parties subject to the provisions of the act. Each contracting party is required by law to make a report of its true profits and excess profit. Such party must, therefore, maintain such accounting records as will enable it to do so. See § 16.8. Among the essentials are the following:

(1) The profit or loss upon a particular contract or subcontract shall be accounted for and fully explained in the books of account separately on each contract or subcontract.

(2) Any cost accounting methods, however standard they may be and regardless of long continued practice, shall be controlled by, and be in accord with, the objectives and purposes of the act and of any regulations prescribed thereunder.

(3) The accounts shall clearly disclose the nature and amount of the different items of cost of performing a contract or subcontract.

(b) In cases where it has been the custom priorly to use so-called "normal" rates of overhead expense or administrative expenses, or "standard" or "normal" prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract of such methods in charging the contract or subcontract, if the method of accounting employed is such as clearly to reflect, in the final determination upon the books of account, the actual profit derived from the performance of the contract or subcontract and if the necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts. As to the elements of cost, see § 16.8.

(c) All books, records, and original evidences of costs (including, among other things, production orders, bills or schedules of materials, purchase requisitions, purchase orders, vouchers, requisitions for materials, standing expense orders, inventories, labor time cards, pay rolls, cost distribution sheets) pertinent to the determination of the true profit, excess profit, deficiency in profit or net loss from the performance of a contract or subcontract shall be kept at all times available for inspection by internal-revenue officers, and shall be carefully preserved and retained so long as the contents thereof may become material in the administration of the act. This provision is not confined to books, records, and original evidences pertaining to items which may be considered to be a part of the cost of performing a contract or subcontract. It is applicable to all books, records, and original evidences of costs of each plant, branch or department involved in the performance of a contract or subcontract or in the allocation or distribution of costs to the contract or subcontract.

§ 16.14 *Report to Secretary of the Army.* (a) Upon the completion of a contract or subcontract coming within the scope of the act and the regulations in this part, the contracting party is required to make a report, under oath, to the Secretary of the Army. As to the date of completion of a contract or subcontract, see § 16.4. Such report shall be in the form prescribed by the Secretary of the Army and shall state the total contract price, the cost of performing the contract, the net income from such contract, and the per centum such income bears to the contract price. The contracting party shall also include as a part of such report a statement showing:

(1) the manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract (see § 16.8);

(2) the name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) the name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business and are pertinent to the determination of the excess profit.

(b) A copy of the report required to be made to the Secretary of the Army is

required to be transmitted by the contracting party to the Secretary of the Treasury. Such copy shall not be transmitted directly to the Secretary of the Treasury but shall be filed as a part of the annual report. See § 16.15.

§ 16.15 *Annual reports for income-taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party's income-taxable year ending after April 3, 1939 shall file with the collector of internal revenue for the collection district in which the contracting party's Federal income tax returns are required to be filed an annual report on the prescribed form of the profit and excess profit on all contracts and subcontracts coming within the scope of the act and the regulations in this part and completed within the particular income-taxable year. There shall be included as a part of such report a statement, preferably in columnar form, showing separately for each such contract or subcontract completed by the contracting party within the income-taxable year the total contract price, the cost of performing the contract or subcontract and the resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon all contracts and subcontracts completed within the income-taxable year and the amount of the excess profit, if any, for the income-taxable year covered by the report. A copy of the report made to the Secretary of the Army (see § 16.14) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 16.1), the report required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts coming within the scope of the act and the regulations in this part completed by a contracting party within an income-taxable year must be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date an annual report as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual report required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various collectors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the collector of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§ 16.16 *Payment of excess profit liability.* The amount of the excess profit liability to be paid to the United States shall be paid on or before the due date for filing the report with the collector of internal revenue. See § 16.15. At the option of the contracting party, the amount of the excess profit liability may 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 excess profit 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.

§ 16.17 *Liability of surety.* The surety under contracts entered into with the Secretary of the Army for the construction or manufacture of any complete aircraft or any portion thereof for the Army shall not be liable for payment of excess profit due the United States in respect of such contracts.

§ 16.18 *Determination of liability for excess profit, interest and penalties; assessment, collection, payment, refunds.* (a) The duty of determining the correct amount of excess profit liability on contracts and subcontracts coming within the scope of the act and the regulations in this part is upon the Commissioner of Internal Revenue. Under section 3 (b) of the act of March 27, 1934, as last amended, all provisions of law (including the provisions of law relating to interest, penalties and refunds) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934 and

not inconsistent with section 3 of the act of March 27, 1934, as last amended, are applicable with respect to the assessment, collection, or payment of excess profits on contracts and subcontracts coming within the scope of the act and the regulations in this part and to refunds of overpayments of profits into the Treasury under the act. Claims by a contracting party for the refund of an amount of excess profit, interest, penalties, and additions to such excess profit shall conform to the general requirements prescribed with respect to claims for refund of overpayments of taxes imposed by Title I of the Revenue Act of 1934 and, if filed on account of any additional costs incurred pursuant to guarantee provisions in a contract, shall be supplemented by a statement under oath showing the amount and nature of such costs and all facts pertinent thereto.

(b) Administrative procedure for the determination, assessment and collection of excess profit liability under the act and the regulations in this part and the examination of reports and claims in connection therewith will be prescribed from time to time by the Commissioner of Internal Revenue.

Part 17—Excess Profits on Navy Contracts

REGULATIONS FOR INCOME-TAXABLE YEARS ENDING AFTER APRIL 3, 1939

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AUTHORITY: §§ 17.1 to 17.19 issued under 52 Stat. 467; 26 U. S. C. 3791. Interpret or apply sec. 3, 48 Stat. 505, as amended, 53 Stat. 112; 34 U. S. C. 496, 26 U. S. C. 650, 651.

SOURCE: §§ 17.1 to 17.19 contained in Treasury Decision 4906, 4 F. R. 2492.

§ 17.1 *Definitions.* As used in the regulations in this part the term:

(a) "Act" means the act of March 27, 1934 (48 Stat. 505; 34 U. S. C. 496), as originally enacted, as amended by the act of June 25, 1936 (49 Stat. 1926; 34 U. S. C. 496), and as further amended by the act of April 3, 1939 (53 Stat. 560; 34 U. S. C. 496).

(b) "Person" includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation or venture is carried on.

(c) "Contract" means an agreement made by authority of the Secretary of the Navy for the construction or manufacture of any complete naval vessel or aircraft, or any portion thereof.

(d) "Contractor" means a person entering into a direct contract with the Secretary of the Navy or his duly authorized representative.

(e) "Subcontract" means an agreement entered into by one person with another person for the construction or manufacture of a complete naval vessel or aircraft or any portion thereof, the prime contract for such vessel or aircraft or portion thereof having been entered into between a contractor and the Secretary of the Navy or his duly authorized representative.

(f) "Subcontractor" means any person other than a contractor entering into a subcontract.

(g) "Contracting party" means a contractor or subcontractor as the case may be.

(h) "Contract price" or "total contract price" means the amount or total amount to be received under a contract or subcontract as the case may be.

(i) "Income-taxable year" means the calendar year, the fiscal year ending during such calendar year, or the fractional part of such calendar or fiscal year, upon the basis of which the contracting party's net income is computed and for which its income tax returns are made for Federal income tax purposes.

§ 17.2 *Scope of this part.* The regulations in this part deal with liability for excess profit on contracts and subcontracts for the construction or manufacture of any complete naval vessel or aircraft or any portion thereof completed within income-taxable years ending after April 3, 1939. As to the date of the completion of a contract or subcontract, see § 17.5.

§ 17.3 *Contracts and subcontracts under which excess profit liability may be incurred.* Except as otherwise provided with respect to contracts or subcontracts for certain scientific equipment (see § 17.4), every contract awarded for an amount exceeding $10,000 and entered into after the enactment of the act of March 27, 1934 for the construction or manufacture of any complete naval vessel or aircraft, or any portion thereof, is subject to the provisions of the act relating to excess profit liability. Any subcontract made with respect to such a contract and involving an amount in excess of $10,000 is also within the scope of the act. If a contracting party places orders with another party, aggregating an amount in excess of $10,000, for articles or materials which constitute a part of the cost of performing the contract or subcontract, the placing of such orders shall constitute a subcontract within the scope of the act, unless it is clearly shown that each of the orders involving $10,000 or less is a bona fide separate and distinct subcontract and not a subdivision made for the purpose of evading the provisions of the act.

§ 17.4 *Contracts or subcontracts for scientific equipment.* No excess profit liability is incurred upon a contract or subcontract entered into after the amendment of section 3 (b) of the act of June 25, 1936, if at the time or prior to the time such contract or subcontract is made it is designated by the Secretary of the Navy as being exempt under the provisions of the act pertaining to scientific equipment used for communication, target detection, navigation, or fire control. The exemption of contracts or subcontracts for scientific equipment does not extend to any contract or subcontract entered into prior to the enactment of such amendment of section 3 (b) of the act.

§ 17.5 *Completion of contract defined.* The date of delivery of the vessel, aircraft or portion thereof covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of the Navy and the Secretary of the Treasury or their duly authorized representatives. Except as otherwise provided in the preceding sentence, the replacement of defective parts of delivered articles or the performance of other guarantee work in respect to such articles will not operate to extend the date of completion. As to the treatment of the cost of such work as a cost of performing a contract or subcontract, see § 17.9 (h). As to a refund in case of adjustment due to any subsequently incurred additional costs, see § 17.19. If a contract or subcontract is at any time cancelled or terminated, it is completed at the time of the cancellation or termination.

§ 17.6 *Manner of determining liability with respect to contracts or subcontracts for complete naval vessels or portions thereof.* If in an income-taxable year ending after April 3, 1939 a contracting party completes one or more contracts or subcontracts coming within the scope of the act and entered into for the construction or manufacture of any complete naval vessel or any portion thereof, the amount of excess profit to be paid to the United States with respect to all such contracts and subcontracts completed within the income-taxable year shall be computed as follows:

(a) The first step is to ascertain the total contract prices of all such contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see §§ 17.1 and 17.8.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts (see § 17.9) and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step.

The amount remaining after such subtraction is the amount of net profit or net loss upon such contracts and sub-

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contracts completed within the income-taxable year.

(c) The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 10 percent of the total contract prices of such contracts and subcontracts completed within the income-taxable year; and

(2) The amount of any net loss which was sustained in the preceding income-taxable year with respect to contracts or subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof (see § 17.10 (a)).

The amount remaining after such subtraction is the amount of excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit as computed in the third step (see § 17.11) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof and completed within the income-taxable year.

(e) The application of the provisions of this section of the regulations may be illustrated by the following example:

Example: On September 1, 1939 the A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract with the Secretary of the Navy for the construction of portions of a naval vessel coming within the scope of the act, the total contract price of which was $200,000. On March 10, 1940 the A Corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940 the A Corporation also completed at a loss of $10,000 two contracts entered into for the construction or manufacture of naval aircraft coming within the scope of the act. For the year 1939 the A Corporation sustained a net loss of $2,500 on all contracts and subcontracts for any complete naval vessel or any portion thereof coming within the scope of the act and completed within the calendar year 1939. For the year 1939 the A Corporation also sustained a net loss of $1,800 on all other contracts and subcontracts coming within the scope of the act which were completed within the calendar year 1939. For purposes of Federal income tax, the net income of the A Corporation for the year 1940 amounted to $96,000, which amount included the net profit of $40,000 upon the contracts entered into on September 1, 1939 and March 10, 1940. For the year 1940 the A Corporation paid Federal income taxes amounting to $19,200. The excess profit liability of the A Corporation for 1940 is payable with respect to the contracts for portions of a naval vessel which were completed in 1940. The loss of $10,000 on other contracts completed in 1940 and the net loss of $1,800 for 1939 on contracts and subcontracts for naval aircraft do not enter into the computation of such liability. Accordingly, the excess profit liability of the A Corporation for 1940 is $10,800 computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less:		
10 percent of total contract prices (10 percent of $240,000)	$24,000	
Net loss from 1939	2,500	
		26,500
Excess profit for year 1940		13,500
Less credit for Federal income taxes (Federal income tax on $13,500 at rates for 1940)		2,700
Amount of excess profit payable to the United States		10,800

§ 17.7 *Manner of determining liability with respect to contracts or subcontracts for complete naval aircraft or portions thereof.* If in an income-taxable year ending after April 3, 1939 a con-

tracting party completes one or more contracts or subcontracts coming within the scope of the act and entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, the amount of excess profit to be paid to the United States with respect to all such contracts and subcontracts completed within the income-taxable year shall be computed as follows:

(a) The first step is to ascertain the total contract prices of all such contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see §§ 17.1 and 17.8.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts (see § 17.9) and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step.

The amount remaining after such subtraction is the amount of net profit or net loss upon such contracts and subcontracts completed within the income-taxable year.

(c) The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 12 percent of the total contract prices of such contracts and subcontracts completed within the income-taxable year;

(2) The amount of any net loss which was sustained in a prior income-taxable year with respect to contract or subcontracts for the construction or manufacture of any complete naval aircraft or any portion thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof (see § 17.10 (b)); and

(3) The amount of any deficiency in profit which was sustained in a prior income-taxable year with respect to contracts or subcontracts entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof (see § 17.10 (c)).

The amount remaining after such subtraction is the amount of excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit as computed in the third step (see § 17.11) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof and completed within the income-taxable year.

(e) The application of the provisions of this section of the regulations may be illustrated by the following example:

Example: On September 1, 1939, the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract with the Secretary of the Navy for the construction of aircraft coming within the scope of the act, the total contract price of which was $200,000. On March 10, 1940, the B Corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940 the B Corporation also completed at a loss of $10,000 two contracts entered into for the construction or manufacture of portions of a naval vessel coming within the scope of the act. For the year 1939 the B Corporation sustained a net loss of $2,500 and a deficiency in profit of $1,000 on all contracts and subcontracts for naval aircraft coming within the scope of the act and completed within the calendar year 1939. For the year 1939 the B Corporation also sustained a net loss of $1,800 on all other contracts and subcontracts coming within the scope of the act which were completed within the calendar year 1939. For purposes of the Federal income tax, the net income of the B Corporation for the year 1940 amounted to $96,000, which amount included the net profit of $40,000 upon the contracts entered into on September 1, 1939, and March 10, 1940. For the year 1940 the B Corporation paid Federal income taxes amounting to $19,200. The excess profit liability of the B Corporation

for 1940 is payable with respect to the contracts for naval aircraft which were completed in 1940. The loss of $10,000 on other contracts completed in 1940 and the net loss of $1,800 for 1939 on contracts and subcontracts other than for naval aircraft do not enter into the computation of such liability. Accordingly, the excess profit liability of the B Corporation for 1940 is $6,700 computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less cost of performing contracts:		
Contract No 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less:		
12 percent of total contract prices (12 percent of $240,000)	$28,800	
Net loss from 1939	2,500	
Deficiency in profit from 1939	1,000	
		32,300
Excess profit for year 1940		7,700
Less credit for Federal income taxes (Federal income tax on $7,700 at rates for 1940)		1,000
Amount of excess profit payable to the United States		6,700

§ 17.8 *Total contract price.* The total contract price of a particular contract or subcontract (see § 17.1) may be received in money or its equivalent. If something other than money is received, only the fair market value of the thing received, at the date of receipt, is to be included in determining the amount received. Bonuses earned for bettering performance and penalties incurred for failure to meet the contract guarantees are to be regarded as adjustments of the original contract price. Trade or other discounts granted by a contracting party in respect of a contract or subcontract performed by such party are also to be deducted in determining the true total contract price of such contract or subcontract.

§ 17.9 *Cost of performing a contract or subcontract*—(a) *General rule.* The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs, including therein expenditures for materials, direct labor and direct expenses, incurred by the contracting party in performing the contract or subcontract; and (2) the proper proportion of any indirect costs (including therein a reasonable proportion of management expenses) incident to and necessary for the performance of the contract or subcontract.

(b) *Elements of cost.* No definitions of the elements of cost may be stated which are of invariable application to all contractors and subcontractors. In general, the elements of cost may be defined for purposes of the act as follows:

(1) Manufacturing cost, which is the sum of factory cost (see paragraph (c) of this section) and other manufacturing cost (see paragraph (d) of this section);

(2) Miscellaneous direct expenses (see paragraph (e) of this section);

(3) General expenses, which are the sum of indirect engineering expenses, usually termed "engineering overhead" (see paragraph (f) of this section) and expenses of distribution, servicing and administration (see paragraph (g) of this section); and

(4) Guarantee expenses (see paragraph (h) of this section).

(c) *Factory cost.* Factory cost is the sum of the following:

(1) *Direct materials.* Materials, such as those purchased for stock and subsequently issued for contract operations and those acquired under subcontracts, which become a component part of the finished product or which are used directly in fabricating, converting or processing such materials or parts.

(2) *Direct productive labor.* Productive labor, usually termed "shop labor," which is performed on and is properly chargeable directly to the article manufactured or constructed pursuant to the contract or subcontract, but which ordinarily does not include direct engineering labor (see subparagraph (3) of this paragraph).

(3) *Direct engineering labor.* The compensation of professional engineers and other technicists (including reasonable advisory fees), and of draftsmen, properly chargeable directly to the cost of the contract or subcontract.

(4) *Miscellaneous direct factory charges.* Items which are properly chargeable directly to the factory cost of performing the contract or subcontract but which do not come within the classi-

fications in subparagraphs (1), (2), and (3) of this paragraph, as for example, royalties which the contracting party pays to another party and which are properly chargeable to the cost of performing the contract or subcontract (but see paragraph (d) of this section).

(5) *Indirect factory expenses.* Items, usually termed "factory overhead," which are not directly chargeable to the factory cost of performing the contract or subcontract but which are properly incident to and necessary for the performance of the contract or subcontract and consist of the following:

(i) *Labor.* Amounts expended for factory labor, such as supervision and inspection, clerical labor, timekeeping, packing and shipping, stores supply, services of tool crib attendants, and services in the factory employment bureau, which are not chargeable directly to productive labor of the contract or subcontract.

(ii) *Materials and supplies.* The cost of materials and supplies for general use in the factory in current operations, such as shop fuel, lubricants, heat-treating, plating, cleaning and anodizing supplies, nondurable tools and gauges, stationery (such as time tickets and other forms), and boxing and wrapping materials.

(iii) *Service expenses.* Factory expenses of a general nature, such as those for power, heat and light (whether purchased or produced), ventilation and air-conditioning and operation and maintenance of general plant assets and facilities.

(iv) *Fixed charges and obsolescence.* Recurring charges with respect to property used for manufacturing purposes of the contract or subcontract, such as premiums for fire and elevator insurance, property taxes, rentals and allowances for depreciation of such property, including maintenance and depreciation of reasonable standby equipment; and depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract. In making allowances for depreciation, consideration shall be given to the number and length of shifts.

(v) *Miscellaneous indirect factory expenses.* Miscellaneous factory expenses not directly chargeable to the factory cost of performing the contract or subcontract, such as purchasing expenses; ordinary and necessary expenses of rearranging facilities within a department or plant; employees' welfare expenses; premiums or dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to factory employees; factory accident compensation (as to self-insurance, see paragraph (g) of this section); but not including any amounts which are not incident to services, operations, plant, equipment or facilities involved in the performance of the contract or subcontract.

(d) *Other manufacturing cost.* Other manufacturing cost as used in paragraph (b) of this section includes items of manufacturing costs which are not properly or satisfactorily chargeable to factory costs (see paragraph (c) of this section) but which upon a complete showing of all pertinent facts are properly to be included as a cost of performing the contract or subcontract, as for instance, payments of royalties and amortization of the cost of designs purchased and patent rights over their useful life; and "deferred" or "unliquidated" experimental and development charges. For example, in case experimental and development costs have been properly deferred or capitalized and are amortized in accordance with a reasonably consistent plan, a proper portion of the current charge, determined by a ratable allocation which is reasonable in consideration of the pertinent facts, may be treated as a cost of performing the contract or subcontract. In the case of general experimental and development expenses which may be charged off currently, a reasonable portion thereof may be allocated to the cost of performing the contract or subcontract. If a special experimental or development project is carried on in pursuance of a contract, or in anticipation of a contract which is later entered into, and the expense is not treated as a part of general experimental and development expenses or is not otherwise allowed as a cost of performing the contract, there clearly appearing no reasonable prospect of an additional contract for the type of article involved, the entire cost of such project may be allowed as a part of the cost of performing the contract.

(e) *Miscellaneous direct expenses.* Miscellaneous direct expenses as used in paragraph (b) of this section include:

(1) *Cost of installation and construction.* Cost of installation and construction includes the cost of materials, labor and expenses necessary for the erection and installation prior to the completion of the contract and after the delivery of the product or material manufactured or constructed pursuant to the contract or subcontract.

(2) *Sundry direct expenses.* Items of expense which are properly chargeable directly to the cost of performing a contract or subcontract and which do not constitute guarantee expenses (see paragraph (h) of this section) or direct costs classified as factory cost or other manufacturing cost (see paragraphs (c) and (d) of this section), such as premiums on performance or other bonds required under the contract or subcontract; State sales taxes imposed on the contracting party; freight on outgoing shipments; fees paid for wind tunnel and model basin tests; demonstration and test expenses; crash insurance premiums; traveling expenses. In order for any such item to be allowed as a charge directly to the cost of performing a contract or subcontract, (i) a detailed record shall be kept by the contracting party of all items of a similar character, and (ii) no item of a similar character which is properly a direct charge to other work shall be allowed as a part of any indirect expenses in determining the proper proportion thereof chargeable to the cost of performing the contract or subcontract. As to allowable indirect expenses, see paragraphs (c) (5), (f), (g) and (j) of this section.

(f) *Indirect engineering expenses.* Indirect engineering expenses, usually termed "engineering overhead," which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprise the general engineering expenses which are incident to and necessary for the performance of the contract or subcontract, such as the following:

(1) *Labor.* Reasonable fees of engineers employed in a general consulting capacity, and compensation of employees for personal services to the engineering department, such as supervision, which is properly chargeable to the contract or subcontract, but which is not chargeable as direct engineering labor (see paragraph (c) (3) of this section).

(2) *Material.* Supplies for the engineering department, such as paper and ink for drafting and similar supplies.

(3) *Miscellaneous expenses.* Expenses of the engineering department, such as (i) maintenance and repair of engineering equipment, and (ii) services purchased outside of the engineering department for blue printing, drawing, computing, and like purposes.

(g) *Expenses of distribution, servicing and administration.* Expenses of distribution, servicing and administration, which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprehend the expenses incident to and necessary for the performance of the contract or subcontract, which are incurred in connection with the distribution and general servicing of the contracting party's products and the general administration of the business, such as:

(1) *Compensation for personal services of employees.* The salaries of the corporate and general executive officers and the salaries and wages of administrative clerical employees and of the office services employees such as telephone operators, janitors, cleaners, watchmen and office equipment repairmen.

(2) *Bidding and general selling expenses.* Bidding and general selling expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract. The treatment of bidding and general selling expenses as a part of general expenses in accordance with this paragraph is in lieu of any direct charges which otherwise might be made for such expenses. The term "bidding expenses" as used in this section includes all expenses in connection with preparing and submitting bids.

(3) *General servicing expenses.* Expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract and which are incident to delivered or installed articles and are due to ordinary adjustments or minor defects; but including no items which are treated as a part of guarantee expenses (see para-

graph (h) of this section) or as a part of direct costs, such as direct materials, direct labor, and other direct expense.

(4) *Other expenses.* Miscellaneous office and administrative expenses, such as stationery and office supplies; postage; repair and depreciation of office equipment; contributions to local charitable or community organizations to the extent constituting ordinary and necessary business expenses; employees' welfare expenses; premiums and dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to administrative office employees and accident compensation to office employees (as to self-insurance, see subdivision (i) of this subparagraph).

(i) Subject to the exception stated in this subdivision, in cases where a contracting party assumes its own insurable risks (usually termed "self-insurance"), losses and payments will be allowed in the cost of performing a contract or subcontract only to the extent of the actual losses suffered or payments incurred during, and in the course of, the performance of the contract or subcontract and properly chargeable to such contract or subcontract. If, however, a contracting party assumes its own insurable risks (*a*) for compensation paid to employees for injuries received in the performance of their duties, or (*b*) for unemployment risks in States where insurance is required, there may be allowed as a part of the cost of performing a contract or subcontract a reasonable portion of the charges set up for purposes of self-insurance under a system of accounting regularly employed by the contracting party, as determined by the Commissioner of Internal Revenue, at rates not exceeding the lawful or approved rates of insurance companies for such insurance, reduced by amounts representing the acquisition cost in such companies, provided the contracting party adopts and consistently follows this method with respect to self-insurance in connection with all contracts and subcontracts subsequently performed by him.

(ii) Allowances for interest on invested capital are not allowable as costs of performing a contract or subcontract.

(iii) Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: Entertainment expenses; dues and memberships other than of regular trade associations; donations except as otherwise provided above; losses on other contracts; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; amortization of unrealized appreciation of values of assets; expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacated or abandoned, or not adaptable for future use in performing contracts or subcontracts; increases in reserve accounts for contingencies, repairs, compensation insurance (except as above provided with respect to self-insurance) and guarantee work; Federal and State income and excess-profits taxes and surtaxes; cash discount earned up to one percent of the amount of the purchase, except that all discounts on subcontracts subject to the act will be considered; interest incurred or earned; bond discount or finance charges; premiums for life insurance on the lives of officers; legal and accounting fees in connection with reorganizations, security issues, capital stock issues and the prosecution of claims against the United States (including income tax matters); taxes and expenses on issues and transfers of capital stock; losses on investments; bad debts; and expenses of collection and exchange.

(iv) In order that the cost of performing a contract or subcontract may be accounted for clearly, the amount of any excess profits repayable to the United States pursuant to the act should not be charged to or included in such cost.

(h) *Guarantee expenses.* Guarantee expenses include the various items of factory cost, other manufacturing cost, cost of installation and construction, indirect engineering expenses and other general expenses (see paragraphs (c) to (g) of this section) which are incurred after delivery or installation of the article manufactured or constructed pursuant to the particular contract or subcontract and which are incident to the correction of defects or deficiencies which the contracting party is required to make under the guarantee provisions of the particular contract or subcontract. If the total amount of

such guarantee expenses is not ascertainable at the time of filing the report required to be filed with the collector of internal revenue (see § 17.16) and the contracting party includes any estimated amount of such expenses as part of the claimed total cost of performing the contract or subcontract, such estimated amount shall be separately shown on the report and the reasons for claiming such estimated amount shall accompany the report; but only the amount of guarantee expenses actually incurred will be allowed. If the amount of guarantee expenses actually incurred is greater than the amount (if any) claimed on the report and the contracting party has made an overpayment of excess profit, a refund of the overpayment shall be made in accordance with the provisions of § 17.19. If the amount of guarantee expenses actually incurred is less than the amount claimed on the report and an additional amount of excess profit is determined to be due, the additional amount of excess profit shall be assessed and paid in accordance with the provisions of § 17.19.

(i) *Unreasonable compensation.* (1) The salaries and compensation for services which are treated as a part of the cost of performing a contract or subcontract include reasonable payments for salaries, bonuses, or other compensation for services. As a general rule, bonuses paid to employees (and not to officers) in pursuance of a regularly established incentive bonus system may be allowed as a part of the cost of performing a contract or subcontract.

(2) The test of allowability is whether the aggregate compensation paid to each individual is for services actually rendered incident to, and necessary for, the performance of the contract or subcontract, and is reasonable. Excessive or unreasonable payments whether in cash, stock or other property ostensibly as compensation for services shall not be included in the cost of performing a contract or subcontract.

(j) *Allocation of indirect costs.* No general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract. Subject to a requirement that all items which have no relation to the performance of the contract or subcontract shall be eliminated from the amount to be allocated, the following methods of allocation are outlined as acceptable in a majority of cases:

(1) *Factory indirect expenses.* The allowable indirect factory expenses (see paragraph (c) (5) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct productive labor (see paragraph (c) (2) of this section) attributable to the contract or subcontract bears to the total direct productive labor of the production department or particular section thereof during the period within which the contract or subcontract is performed, except that if the indirect factory expenses are incurred in different amounts and in different proportions by the various producing departments consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination of the true profit and excess profit.

(2) *Engineering indirect expenses.* The allowable indirect engineering expenses (see paragraph (f) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct engineering labor attributable to the contract or subcontract (see paragraph (c) (3) of this section) bears to the total direct engineering labor of the engineering department or particular section thereof during the period within which the contract or subcontract is performed. If the expenses of the engineering department are not sufficient in amount to require the maintenance of separate accounts, the engineering indirect costs may be included in the indirect factory expenses (see paragraph (c) (5) of this section) and allocated or distributed to the cost of performing the contract or subcontract as a part of such expenses, provided the proportion so allocated or distributed is proper under the facts and circumstances relating to the performance of the particular contract or subcontract.

(3) *Administrative expenses (or "overhead").* The allowable expenses of administration (see paragraph (g) of this section) or other general expenses except indirect engineering expenses, bidding and general selling expenses, and

general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of the proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

(4) *Bidding, general selling, and general servicing expenses.* The allowable bidding and general selling expenses and general servicing expenses (see paragraph (g) (2) and (3) of this section) shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of:

(i) The proportion which the contract price of the particular contract or subcontract bears to the total sales made (including contracts or subcontracts completed) during the period within which the particular contract or subcontract is performed, or

(ii) The proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed,

except that special consideration shall be given to the relation which certain classes of such expenses bear to the various classes of articles produced by the contracting party in each case in which such consideration is necessary in order to make a fair and reasonable determination of the true profit and excess profit. See § 17.14.

§ 17.10 *Credits for net loss and deficiency in profit in computing excess profit*—(a) *Net loss on contracts and subcontracts for naval vessels or portions thereof.* In the case of contracts or subcontracts for the construction or manufacture of any complete naval vessel or any portion thereof coming within the scope of the act which are completed within an income-taxable year ending after April 3, 1939, the term "net loss" as used in the act and in this part means the amount by which the total costs of performing all such contracts and subcontracts completed within such income-taxable year exceeds the total contract prices of such contracts and subcontracts. Such net loss sustained by a contracting party for an income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of any complete naval vessel or any portion thereof which are completed within the next succeeding income-taxable year.

(b) *Net loss on contracts and subcontracts for naval aircraft or portion thereof.* In the case of contracts or subcontracts for the construction or manufacture of any complete naval aircraft or any portion thereof coming within the scope of the act which are completed within an income-taxable year ending after April 3, 1939, the term "net loss" as used in the act and in this part means the amount by which the total costs of performing all such contracts and subcontracts completed within such income-taxable year exceeds the total contract prices of such contracts and subcontracts. Such net loss sustained by a contracting party for an income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of any complete naval aircraft or any portion thereof which are completed within the four next succeeding income-taxable years.

(c) *Deficiency in profit.* The term "deficiency in profit" as used in the act and in this part relates only to contracts and subcontracts coming within the scope of the act which are for the construction or manufacture of any complete naval aircraft or any portion thereof and are completed within an income-taxable year ending after April 3, 1939. As so used, the term "deficiency in profit" means the amount by which 12 percent of the total contract prices of such contracts and subcontracts which are completed by a particular contracting party within the income-taxable year exceeds the net profit upon such contracts and subcontracts. A deficiency in profit sustained by a contracting party with respect to such contracts and sub-

contracts for the construction or manufacture of complete naval aircraft or any portion thereof and completed within any income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of complete naval aircraft or any portion thereof which are completed within the four next succeeding income-taxable years.

(d) *Claim for credit.* Credit for a deficiency in profit or a net loss may be claimed in the contracting party's annual report of profit filed with the collector of internal revenue (see § 17.16), but it shall be supported by separate schedules for each contract or subcontract involved showing total contract prices, costs of performance and pertinent facts relative thereto, together with a summarized computation of the deficiency in profit or net loss. The deficiency in profit or net loss claimed is subject to verification and adjustment. As to preservation of books and records, see § 17.14. A deficiency in profit or net loss sustained on contracts and subcontracts completed within one income-taxable year may not be considered in computing a net loss or deficiency in profit sustained on contracts and subcontracts completed within another income-taxable year.

(e) *Examples.* The provisions of this section of the regulations may be illustrated by the following examples:

Example 1: For the calendar year 1939 the A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $50,000 upon all contracts and subcontracts coming within the scope of the act which were entered into for the construction or manufacture of any complete naval vessel or any portion thereof and were completed within the calendar year 1939. For the calendar year 1940 the A Corporation had a net profit of $30,000 upon all such contracts and subcontracts completed within the year 1940. It also had a net profit of $10,000 upon other contracts completed within that year, all such contracts being for naval aircraft coming within the scope of the act. For the calendar year 1941 the corporation had a net profit of $25,000 upon contracts completed within that year. The net loss of $50,000 sustained in 1939 may be taken as a credit against the net profit of $30,000 realized in 1940 upon the contracts for the construction or manufacture of complete naval vessels or portions thereof completed within that year; but the excess of $20,000 ($50,000 minus $30,000) may not be taken as a credit in computing the excess profit realized upon the other contracts completed in 1940 at a net profit of $10,000 or as a credit in computing the excess profit upon the contracts completed within the year 1941 at a net profit of $25,000.

Example 2: For the calendar year 1939 the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $10,000 and a deficiency in profit of $35,000 upon all contracts and subcontracts for naval aircraft and portions thereof coming within the scope of the act and completed within that year. On all contracts and subcontracts for naval aircraft coming within the scope and completed within the calendar year 1940 the B Corporation realized a net profit which was $20,000 in excess of 12 percent of the total contract prices of such contracts. The net loss of $10,000 and deficiency in profit of $35,000 (or a total of $45,000) sustained in 1939 with respect to contracts and subcontracts for naval aircraft completed within that year may be taken as a credit to the extent of $25,000 in computing the excess profit on the contracts and subcontracts for naval aircraft completed in 1940. The remainder of such net loss and such deficiency in profit ($45,000 minus $25,000 or $20,000) may be taken as a credit in computing the excess profit realized on the contracts and subcontracts for naval aircraft completed in the year 1941.

§ 17.11 *Credit for Federal income taxes.* For the purpose of computing the amount of excess profit to be paid to the United States, a credit is allowable against the excess profit for the amount of Federal income taxes paid or remaining to be paid on the amount of such excess profit. The "Federal income taxes" in respect of which this credit is allowable include the income taxes imposed by Titles I and IA of the Revenue Act of 1938, and chapter 1 and subchapter A of chapter 2 of the Internal Revenue Code, and the excess-profits taxes imposed by section 602 of the Revenue Act of 1938, and subchapter B of chapter 2 of the Internal Revenue Code. This credit is allowable for these taxes only to the extent that it is affirmatively shown that they have been finally determined and paid or remain to be paid and that they were imposed upon the excess profit against which the credit is to be made. In case such a credit has been allowed and the amount of Federal income taxes imposed upon the excess profit is redetermined, the credit previously allowed shall be accordingly adjusted.

§ 17.12 *Failure of contractor to require agreement by subcontractor.* (a) Every contract or subcontract coming within the scope of the act is required by the act to contain, among other things, an agreement by the contracting party to make no subcontract unless the subcontractor agrees:

(1) To make a report, as described in the act, under oath to the Secretary of the Navy upon the completion of the subcontract;

(2) To pay into the Treasury excess profit, as determined by the Treasury Department, in the manner and amounts specified in the act;

(3) To make no subdivision of the subcontract for the same article or articles for the purpose of evading the provisions of the act;

(4) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and adult as provided in the act.

(b) If a contracting party enters into a subcontract with a subcontractor who fails to make such agreement, such contracting party shall, in addition to its liability for excess profit determined on contracts or subcontracts performed by it, be liable for any excess profit determined to be due the United States on the subcontract entered into with such subcontractor. In such event, however, the excess profit to be paid to the United States in respect of the subcontract entered into with such subcontractor shall be determined separately from any contracts or subcontracts performed by the contracting party entering into the subcontract with such subcontractor.

§ 17.13 *Evasion of excess profit.* Section 3 of the act provides that the contracting party shall agree to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of the act. If any such subdivision or subcontract is made it shall constitute a violation of the agreement provided for in the act, and the cost of completing a contract or subcontract by a contracting party which violates such agreement shall be determined in a manner necessary clearly to reflect the true excess profit of such contracting party.

§ 17.14 *Books of account and records.* (a) It is recognized that no uniform method of accounting can be prescribed for all contracting parties subject to the provisions of the act. Each contracting party is required by law to make a report of its true profit and excess profit. Such party must, therefore, maintain such accounting records as will enable it to do so. See § 17.9. Among the essentials are the following:

(1) The profit or loss upon a particular contract or subcontract shall be accounted for and fully explained in the books of account separately on each contract or subcontract.

(2) Any cost accounting methods, however standard they may be and regardless of long continued practice, shall be controlled by, and be in accord with, the objectives and purposes of the act and of any regulations prescribed thereunder.

(3) The accounts shall clearly disclose the nature and amount of the different items of cost of performing a contract or subcontract.

(b) In cases where it has been the custom priorly to use so-called "normal" rates of overhead expense or administrative expenses, or "standard" or "normal" prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract of such methods in charging the contract or subcontract, if the method of accounting emoplyed is such as clearly to reflect, in the final determination upon the books of account, the actual profit derived from the performance of the contract or subcontract and if the necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts. As to the elements of cost, see § 17.9.

(c) All books, records, and original evidences of costs (including, for example, production orders, bills or schedules of materials, purchase requisitions, purchase orders, vouchers, requisitions for materials, standing expense orders, inventories, labor time cards, payrolls, cost distribution sheets) pertinent to the determination of the true profit, excess profit, deficiency in profit, or net loss from the performance of a contract or subcontract shall be kept at all times available for inspection by internal revenue officers, and shall be carefully preserved and retained so long as the contents thereof may become material in the administration of the act. This provi-

sion is not confined to books, records and original evidences pertaining to items which may be considered to be a part of the cost of performing a contract or subcontract. It is applicable to all books, records and original evidences of costs of each plant, branch or department involved in the performance of a contract or subcontract or in the distribution of costs to the contract or subcontract.

§ 17.15 *Report to Secretary of the Navy.* (a) Upon the completion of a contract or a subcontract coming within the scope of the act and this part, the contracting party is required to make a report, under oath, to the Secretary of the Navy. As to the date of completion of a contract or subcontract, see § 17.5. The act requires that such report shall be in the form prescribed by the Secretary of the Navy and shall state the total contract price, the cost of performing the contract, the net income from such contract, and the per centum such income bears to the contract price. The contracting party shall also include as a part of such report a statement showing:

(1) The manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract (see § 17.9);

(2) The name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) The name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business and are pertinent to the determination of the excess profit.

(b) A copy of the report required to be made to the Secretary of the Navy is required to be transmitted by the contracting party to the Secretary of the Treasury. Such copy shall not be transmitted directly to the Secretary of the Treasury but shall be filed as a part of the annual report. See § 17.16.

§ 17.16 *Annual reports for income-taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party's income-taxable year ending after April 3, 1939 shall file, with the collector of internal revenue for the collection district in which the contracting party's Federal income tax return is required to be filed, annual reports on the prescribed forms of the profit and excess profit on all contracts and subcontracts coming within the scope of the act. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval vessel or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.6. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.7. There shall be included as a part of the annual report a statement, preferably in columnar form, showing separately for each contract or subcontract completed by the contracting party within the income-taxable year and covered by the report, the total contract price, the cost of performing the contract or subcontract and resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon each group of contracts and subcontracts covered by the report and the amount of the excess profit, if any, with respect to each group of contracts and subcontracts covered by the report. A copy of the report made to the Secretary of the Navy (see § 17.15) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 17.1), the reports required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts completed by a contracting party within an income-taxable year ending after April 3, 1939 shall be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is im-

portant that the contracting party render on or before the due date annual reports as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual reports required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various collectors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the collector of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§ 17.17 *Payment of excess profit liability.* The amount of the excess profit liability to be paid to the United States shall be paid on or before the due date for filing the report with the collector of internal revenue. See § 17.16. At the option of the contracting party, the amount of the excess profit liability may 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 excess profit 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.

§ 17.18 *Liability of surety.* The surety under contracts entered into after the amendment of section 3 (b) of the act of June 25, 1936 shall not be liable for payment of excess profit due the United States in respect of such contracts.

§ 17.19 *Determination of liability for excess profit, interest and penalties; assessment, collection, payment, refunds.* (a) The duty of determining the correct amount of excess profit liability on contracts and subcontracts coming within the scope of the act is upon the Commissioner of Internal Revenue. Under section 3 (b) of the act, as amended, and section 651 of the Internal Revenue Code, all provisions of law (including the provisions of law relating to interest, penalties and refunds) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934 and not inconsistent with section 3 of the act are applicable with respect to the assessment, collection, or payment of excess profits on contracts and subcontracts coming within the scope of the act and to refunds of overpayments of profits into the Treasury under the act. Claims by a contracting party for the refund of an amount of excess profit, interest, penalties, and additions to such excess profit shall conform to the general requirements prescribed with respect to claims for refund of overpayments of taxes imposed by Title I of the Revenue Act of 1934 and, if filed on account of any additional costs incurred pursuant to guarantee provisions in a contract, shall be supplemented by a statement under oath showing the amount and nature of such costs and all facts pertinent thereto.

(b) Administrative procedure for the determination, assessment and collection of excess profit liability under section 3 of the act, sections 650 and 651 of the Internal Revenue Code, and this part, and the examination of reports and claims in connection therewith will be prescribed from time to time by the Commissioner of Internal Revenue.

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23.34 Sale of stock; basis for determining gain or loss.
23.35 Sale of bonds or other obligations; basis for determining gain or loss.
23.36 Limitation on allowable losses on sale of stock or bonds or other obligations.
23.37 Liquidations; recognition of gain or loss.
23.38 Basis of property.
23.39 Inventories.
23.40 Bad debts.
23.41 Sale and retirement by corporation of its bonds.
23.42 Limitation on capital losses.
23.43 Credit for foreign taxes.
23.44 Methods of accounting.

AUTHORITY: §§ 23.0 to 23.44 issued under 53 Stat. 36; 26 U. S. C. 62. Interpret or apply 53 Stat. 58, as amended, 880; 26 U. S. C. 141, 152.

GENERAL PROVISIONS

§ 23.0 *Introductory.* (a) The regulations in this part, authorized by sections 141 (b) and 152 of the Internal Revenue Code, as amended, are prescribed as a supplement to the income tax regulations applicable generally under the Code. They are applicable in the case of all corporations (with certain statutory exceptions) with respect to all taxable years beginning after December 31, 1941. They are applicable further in the case of railroad corporations with respect to all taxable years beginning after December 31, 1931, (not including taxable years for which the return was filed prior to December 28, 1939) and in the case of Pan-American trade corporations, with respect to all taxable years beginning after December 31, 1939. In the case of railroad corporations filing their return prior to December 28, 1939 (the date of approval of the regulations in this part), Regulations 97 (26 CFR, 1938 ed., Part 4) prescribed under section 141 (b) of the Revenue Act of 1936, are applicable insofar as not inconsistent with the provisions of the Code.

(b) The several sections of the regulations in this part have been given numbers corresponding respectively to the article numbers of prior consolidated returns regulations but, in accordance with the rules of the FEDERAL REGISTER, preceded by the Code number 23.

(c) The regulations in this part are hereby prescribed pursuant to the authority of sections 141 (b) and 152 of the Internal Revenue Code, as amended.[1]

[Regs. 104, 5 F. R. 7, as amended by T. D. 5244, 8 F. R. 3283]

§ 23.1 *Privilege of making consolidated returns.* (a) Sections 141 and 152, as amended, give to the corporations of an affiliated group the privilege of making a consolidated return for the taxable year in lieu of separate returns.

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[1] The report of the Committee on Ways and Means (Rept. No. 1860, 75th Cong., 3d sess., p. 44) accompanying the revenue bill of 1938 (the pertinent provisions of which were reenacted without change in substance in the Internal Revenue Code) contains the following statement:

"Among the matters to be detailed in regulations which the Commissioner is expected to prescribe under the provisions of subsection (b) of this section are (*a*) the treatment of inter-company dividend distributions, (*b*) definitions of the 'net income,' the 'adjusted net income,' and the 'special class net income,' of the affiliated group, and (*c*) the computation of the 'net operating loss,' the 'basic surtax credit,' the 'dividend carry-over,' the 'dividends paid credit,' and the capital gains and losses,' insofar as these several factors may pertain to the case of an affiliated group."

With respect to the corresponding section of the Revenue Act of 1928, the report of the Committee on Finance (S. Rept. No. 960, 70th Cong., 1st sess., p. 15) accompanying the revenue bill of 1928 contains the following statement (a similar statement being contained also in the statement of the managers on the part of the House, accompanying the conference report upon the bill, see H. Rept. No. 1882, 70th Cong., 1st sess., pp. 16–17):

"Among the regulations which it is expected that the Commissioner will prescribe are: (1) The extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group or upon the dissolution (whether partial or complete) of a member of the group; (2) the basis of property (including property included in an inventory) acquired, during the period of affiliation, by a member of the affiliated group, including the basis of such property after such period of affiliation; (3) the extent to which and the manner in which net losses sustained by a corporation before it became a member of the group shall be deducted in the consolidated return; and the extent to which and the manner in which net losses sustained during the period for which the consolidated return is filed shall be deducted in any taxable year after the

This privilege is given, however, for taxable years beginning after December 31, 1941, upon the condition that all corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to the regulations in this part, and any amendments thereof duly prescribed prior to the last day prescribed by law for the filing of the return; and the making of the consolidated return is considered as such consent. The last day prescribed by law for the filing of the return includes the last day of the period of any extension of time granted by the Commissioner. For a taxable year beginning prior to January 1, 1942, the regulations and the amendments thereof to which the taxpayer is required to consent are those duly prescribed prior to the making of the return for such year.

(b) The tax liability of the members of the affiliated group for the taxable year involved will be determined in accordance with the provisions of the regulations to which consent is given and without regard to any changes of the rules therein prescribed made subsequent to the last day prescribed by law for the filing of the return for such year, or, for taxable years beginning prior to January 1, 1942, subsequent to the making of the return for such year.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5244, 8 F. R. 3283]

§ 23.2 *Definitions*—(a) *Code.* The term "Code" means the Internal Revenue Code, as amended, and the sections of statutory law referred to in the regulations in this part, unless otherwise stated, are sections of that Code.

(b) *Affiliated group.* (1) The term "affiliated group" includes:

(i) For taxable years beginning after December 31, 1941, the common parent corporation and every other corporation for the period during which such corporation is a member of the affiliated group within the meaning of section 141 of the Code as amended by section 159 of the Revenue Act of 1942 and section 131 of the Revenue Act of 1943; it does not include (*a*) any corporation which, under section 141, as amended, cannot be included in a consolidated return, (*b*) an insurance company taxable under section 201 or 207 in the case of a consolidated return for corporations taxable under section 13, 14, or 204, (*c*) a corporation taxable under section 13, 14, or 204 in the case of a consolidated return for insurance companies taxable under section 201 or 207, (*d*) an insurance company taxable under section 201 in the case of a consolidated return for insurance companies taxable under section 207, or (*e*) an insurance company taxable under section 207 in the case of a consolidated return for insurance companies taxable under section 201;

(ii) For taxable years beginning prior to January 1, 1942, the common parent corporation and every other corporation for the period during which such corporation is a member of the affiliated

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affiliation is terminated in whole or in part; (4) the extent to which and the manner in which gain or loss is to be recognized, upon the withdrawal of one or more corporations from the group, by reason of transactions occurring during the period of affiliation; and (5) that the corporation filing the consolidated return must designate one of their members as the agent for the group, in order that all notices may be mailed to the agent, deficiencies collected, refunds made, interest computed, and proceedings before the Board of Tax Appeals conducted as though the agent were the taxpayer."

The Report of the Committee on Finance (Rept. No. 1631, 77th Cong., 2d sess., p. 133) accompanying the Revenue Bill of 1942 contains the following statement: "The consolidated normal tax net income, the consolidated corporation surtax net income, and the consolidated capital gains and losses of the group are among those factors with respect to which the Commissioner, in view of experience with current and past consolidated returns regulations, is expected to prescribe regulations in order to reflect clearly the income and excess profits tax liability of the group and of each member thereof and the various factors necessary for the determination of such liability. In addition to these matters, your committee expects that such regulations will provide for the application of the excess profits relief provisions, and the provisions of section 710 (a) (1) (B) limiting excess profits taxes, in cases where consolidated returns are filed. Although the present regulations with respect to the determination of consolidated net income quite properly limit the deduction of the net operating loss carry-over of a member of a group from years prior to that in which its income is first included in a consolidated return to the amount of the separate income of such member, this section provides that such limitation shall not be applied to prevent the portion of the net operating loss carry-over which is attributable to a 1941 war loss of the member (see sec. 158 of the bill) being taken into account in computing consolidated net income."

group within the meaning of section 141 or section 152 of the Code prior to their amendment by the Revenue Act of 1942; it does not include any corporation which, under section 141 or section 152 of the Code, prior to amendment, cannot be included in the consolidated return.

(2) In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for income tax purposes as a domestic corporation. The option to treat such foreign corporation as a domestic corporation so that it may be included in a consolidated return must be exercised at the time of making the consolidated return, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation, it must be included in the consolidated return of the affiliated group of which it is a member for each year thereafter for which such group makes or is required to make a consolidated return.

(3) In the determination of the corporations properly to be included within the affiliated group as "Pan-American trade corporations," the term "Central or South America" as used in section 152 of the Code as amended by section 225 of the Revenue Act of 1939 shall be considered as embracing the territories of British Honduras, Guatemala, Honduras, Salvador, Nicaragua, Costa Rica, Panama, the Panama Canal Zone, Colombia, Venezuela, British Guiana, Dutch Guiana, French Guiana, Ecuador, Peru, Brazil, Bolivia, Chile, Argentina, Paraguay, and Uruguay.

(4) For taxable years beginning after December 31, 1941, an affiliated group of corporations, within the meaning of section 141 of the Code as amended by section 159 of the Revenue Act of 1942 and section 131 of the Revenue Act of 1943, is formed at the time that the common parent corporation, which is an includible corporation, becomes the owner directly of stock possessing at least 95 percent of the voting power of all classes of stock and at least 95 percent of each class of nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends) of another includible corporation; a corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of stock possessing at least 95 percent of the voting power of all classes of its stock and at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends); and a corporation ceases to be a member of such an affiliated group at the time that the members of such group cease to own directly stock possessing at least 95 percent of the voting power of all classes of its stock, or at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends).

(5) In the determination of the includible corporations of the affiliated group for a taxable year beginning after December 31, 1943, a personal service corporation as described in section 725 (a) or a corporation otherwise entitled to exemption from excess profits tax under section 727 (e), (g), or (h) shall be treated as an includible corporation only if it has made and filed pursuant to section 141 (e) (7) its consent to be treated as an includible corporation for such year or for a prior taxable year beginning after December 31, 1943.

(6) For taxable years beginning prior to January 1, 1942, an affiliated group of corporations, within the meaning of sections 141 and 152 of the Code prior to their amendment by the Revenue Act of 1942, is formed at the time the common parent corporation becomes the owner directly of at least 95 percent in the case of railroad corporations, and 100 percent in the case of Pan-American trade corporations, of the stock (as defined by section 141 (d) prior to its amendment) of another corporation; a corporation becomes a member of a railroad 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 becomes a member of a Pan-American affiliated group at the time that the common parent corporation becomes the owner directly of 100 percent of its stock; and a corporation ceases to be a member of an affiliated group when, in the case of railroad corporations, the members of the group cease to own directly 95 percent, or, in the case of Pan-American trade corpo-

rations, the parent corporation ceases to own directly 100 percent, of its stock.

(c) *Consolidated return period.* The term "consolidated return period" means the taxable year 1929, or any subsequent taxable year, for which a consolidated return is made or is required, including the period during which a subsidiary corporation is engaged in distributing its assets in liquidation.

(d) *Subsidiary.* The term "subsidiary" means a corporation (other than the common parent corporation) which is a member of the affiliated group during any part of the consolidated return period.

(e) *Tax.* The term "tax" means the income tax imposed by the Code, and includes any interest, penalty, additional amount, or addition to the tax, payable in respect thereof.

(f) *Consolidated return.* The term "consolidated return" means a consolidated income tax return.

(g) *Terms defined in Internal Revenue Code,* as amended. Terms which are defined in the Code, as amended, shall, when used in the regulations in this part, have the meaning assigned to them by the Code, as amended, unless specifically otherwise defined. (See, for example, "adjusted net income," section 13; "normal-tax net income," section 13 as amended by section 105 (a) of the Revenue Act of 1942; "special class net income," section 14 prior to its amendment by section 201 of the Revenue Act of 1939; "corporation surtax net income," section 15 as amended by section 105 (b) of the Revenue Act of 1942; "net income," section 21; "gross income," section 22; "taxable year" and "fiscal year," section 48 as amended by section 135 (d) of the Revenue Act of 1942; "deficiency," section 271; and the terms defined in section 3797, particularly the terms "person," "stock," and "corporation.")

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3233, T. D. 5441, 10 F. R. 2425]

§ 23.3 *Applicability of other provisions of law.* Any matter in the determination of which the provisions of the regulations in this part are not applicable shall be determined in accordance with the provisions of the Code or other law applicable thereto.

[Regs. 104, 5 F. R. 7]

ADMINISTRATIVE PROVISIONS

§ 23.10 *Exercise of privilege*—(a) *When privilege must be exercised.* (1) The privilege of making a consolidated return under the regulations in this part for any taxable year of an affiliated group must be exercised at the time of making the return of the common parent corporation for such year. Under no circumstances can such privilege be exercised at any time thereafter. The filing of separate returns for a taxable year does not constitute an election binding upon the corporations in subsequent years. If the privilege is exercised at the time of making the return, separate returns cannot thereafter be made for such year. (See, however, § 23.18, relating to the improper inclusion in the consolidated return of the income of a corporation.)

(2) If a consolidated return for a taxable year beginning after December 31, 1938, was made after the enactment of the Internal Revenue Code, approved February 10, 1939, but prior to the prescribing of the regulations in this part, the privilege of making a consolidated return for such year will be considered as having been exercised at the time of the making of such return, and the affiliated group will be considered as having consented to all of the provisions of 26 CFR, 1938 ed., Part 4 insofar as not inconsistent with the Code, as amended. Under no circumstances can separate returns be subsequently made for such taxable year.

(3) If a consolidated return for a taxable year beginning after December 31, 1938, was made prior to the amendment of the Internal Revenue Code by the Revenue Act of 1939, the privilege of making a consolidated return for such year will not be considered to have been exercised at that time but must be exercised at the time of making the return of the common parent corporation for such taxable year under the Code.

(b) *Effect of tentative returns.* In no case will the privilege under paragraph (a) of this section be considered as exercised at the time of making a so-called "tentative return" (made, for example, in order to obtain an extension of time for making the return required by law). However, if any such tentative return is made upon the basis of a consolidated return or a separate return, the return required by law must be made upon the same basis, unless upon the making of

the return required by law (either a separate return or a consolidated return, as the case may be) the payments theretofore made and to be made are adjusted in a manner satisfactory to the Commissioner.

[Regs. 104, 5 F. R. 7]

§ 23.11 *Consolidated returns for subsequent years*—(a) *Consolidated returns required for subsequent years.* If a consolidated return is made under the regulations in this part for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, or (2) Chapter 1 of the Code to the extent applicable to corporations, or the regulations in this part which have been consented to, have been amended and any such amendment is of a character which makes less advantageous to affiliated groups as a class the continued filing of consolidated returns, or (3) the Commissioner, prior to the time of making the return, upon application made by the common parent corporation and for good cause shown, grants permission to change.

(b) *Effect of separate returns when consolidated return required.* If the making of a consolidated return is required for any taxable year, the tax liability of the members of the affiliated group shall be computed in the same manner as if a consolidated return had been made, even though separate returns are made; amounts assessed upon the basis of separate returns shall be considered as having been assessed upon the basis of a consolidated return; and amounts paid upon the basis of separate returns shall be considered as having been paid by the common parent corporation. In such cases the making of separate returns shall not be considered as the making of a return for the purpose of computing any period of limitation or any deficiency. If a consolidated return for such taxable year is thereafter made, such return shall for the purpose of computing periods of limitation and any deficiency be considered as the return for such year.

(c) *When affiliated group remains in existence.* For the purposes of the regulations in this part, an affiliated group shall be considered as remaining in existence if the common parent corporation remains as a common parent and at least one subsidiary remains affiliated with it, whether or not such subsidiary was a member of the group at the time the group was formed and whether or not one or more corporations have become subsidiaries or have ceased to be subsidiaries at any time after the group was formed.

(d) *When affiliated group terminates.* For the purposes of the regulations in this part, an affiliated group shall be considered as terminated if the common parent corporation ceases to be the common parent or if there is no subsidiary affiliated with it.

[Regs. 104 5 F. R. 7, as amended by T. D. 5087, 6 F. R. 5251]

§ 23.12 *Making consolidated return and filing other forms*—(a) *Consolidated return made by common parent corporation.* A consolidated return shall be made on Form 1120 by the common parent corporation for the affiliated group. Such return shall be filed at the time and in the office of the collector of the district prescribed for the filing of a separate return by such corporation.

(b) *Authorizations and consents.* (1) Each subsidiary must prepare duplicate originals of Form 1122, consenting to the regulations in this part and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the affiliated group), for each year thereafter for which, under § 23.11 (a), the making of a consolidated return is required. One of such forms as prepared by each subsidiary shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for the district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

(2) The filing of Form 1122 for a taxable year beginning after December 31, 1943 by a subsidiary which is either a personal service corporation as described in section 725 (a) or a corporation described in section 727 (e), (g), or (h)

shall constitute the making and filing of its consent to be treated as an includible corporation under section 141 (e) (7).

(3) If the common parent corporation is a personal service corporation as described in section 725 (a) or a corporation described in section 727 (e), (g), or (h), the making and filing of the consolidated income tax return for a taxable year beginning after December 31, 1943 shall constitute the making and filing of its consent to be treated as an includible corporation under section 141 (e) (7).

(4) A corporation which consents to be treated as an includible corporation for a taxable year beginning after December 31, 1943 shall be treated as an includible corporation for all subsequent years, regardless of whether the affiliated group of which such corporation is a member during such subsequent years is the same as the affiliated group of which such corporation was a member when such consent was filed. No consent to be treated as an includible corporation under section 141 (e) (7) can be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed.

(c) *Affiliations schedule filed by common parent corporation.* The common parent corporation shall prepare Form 851 (Affiliations Schedule), which shall be attached to the consolidated return, as a part thereof.

(d) *Persons qualified to swear to returns and forms.* Each return or form required to be made or prepared by a corporation must be sworn to by the persons authorized under section 52 to swear to returns of separate corporations. In cases where receivers or trustees in bankruptcy are operating the property or business of corporations, each return or form required to be made or prepared by such corporation must be executed by the receiver or trustee, as the case may be, pursuant to an order or instructions of the court, and be accompanied by a copy of such order or instructions.

(e) *Signatures in case subsidiary has left affiliated group.* Since Form 1122 is required even though, during the taxable year of the common parent corporation, the subsidiary (because of a dissolution or sale of stock, or otherwise) has ceased to be a member of the affiliated group, it may be advisable for the common parent to obtain the proper signatures to the form prior to the time the subsidiary ceases to be a member of the group.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5441, 10 F. R. 2425]

§ 23.13 *Change in affiliated group during taxable year.* (This section has no bearing upon the question whether a consolidated return may or must be made, but relates only to the effect of changes in the affiliated group during the taxable year.)

(a) *General rule.* Except as hereinafter provided in this part, a consolidated return must include the income of the common parent corporation and of each subsidiary for the entire taxable year of the affiliated group.

(b) *Formation of affiliated group after beginning of year.* If an affiliated group is formed after the beginning of the taxable year of the corporation which becomes the common parent corporation, the consolidated return must include the income of the common parent for its entire taxable year (excluding any portion of such year during which its income is included in the consolidated return of another affiliated group) and the income of each subsidiary from the time it became a member of the affiliated group.

(c) *Complete termination of affiliated group prior to close of taxable year.* If an affiliated group is terminated prior to the close of the taxable year of the group, the consolidated return must include the income of the common parent corporation for its entire taxable year (excluding any portion of such year during which its income is included in the consolidated return of another affiliated group) and of each subsidiary for the period prior to the termination. (See § 23.11 (c) and (d) in determining whether the group has terminated.)

(d) *Addition to affiliated group of a subsidiary during year.* If a corporation becomes a member of the affiliated group during the taxable year of the group, the consolidated return must include its income from the time when it became a member of the group.

(e) *Elimination from affiliated group of a subsidiary during year.* If a subsidiary ceases to be a member of the affiliated group during the taxable year of the group, the consolidated return must include its income for the period during which it was a member of the group.

(f) *Period of 30 days or less may be disregarded.* A subsidiary may at its option be considered as having been a member of the affiliated group during the entire taxable year of the group (or during the entire period of the existence of the subsidiary, whichever is shorter) if the period during which it was not a member of such group does not exceed 30 days. If a corporation has been a member of the affiliated group for a period of less than 31 days during the taxable year of the group, it may at its option be considered as not having been a member of the group during the taxable year. An option under this paragraph must be exercised at or before the time when the consolidated return is made.

(g) *Separate returns for periods not included in consolidated return.* If a corporation, during its taxable year (determined without regard to the affiliation), becomes a member of an affiliated group its income for the portion of such taxable year not included in the consolidated return of such group must be included in a separate return (or, if a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return). If a corporation ceases to be a member of the affiliated group during the taxable year of the group, its income for the period after the time when it ceased to be a member of the group must be included in a separate return (or, if it becomes a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return).

(h) *Time for making separate returns for periods not included in consolidated return.* If a corporation, during its taxable year (determined without regard to the affiliation), becomes a member of an affiliated group, the separate return required for the portion of such taxable year during which it was not a member of the group must be made on or before the fifteenth day of the third month following the close of its taxable year (determined without regard to affiliation). For example, Corporation P, reporting its income on a calendar year basis, acquires on January 1, 1939, all the stock of Corporation S, which reports its income on a fiscal year basis ending March 31. P and S elect to make a consolidated return for the calendar year 1939. The separate return of S for the taxable period April 1, 1938, to December 31, 1938, should be made on or before June 15, 1939.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784]

§ 23.14 *Accounting period of an affiliated group.* (a) The taxable year of an affiliated group which makes a consolidated income tax return shall be the same as the taxable year of the common parent corporation; and, upon having elected to file consolidated returns, each subsidiary corporation shall, not later than the close of the first consolidated income tax taxable year ending thereafter, adopt an annual accounting period, fiscal year or calendar year as the case may be, in conformity with that of the common parent.

(b) If a change of accounting period is made by a subsidiary in order to conform with that of the common parent and if the requirements of Regulations 103 (26 CFR, 1938 ed. Supps., 19.46–1) relating to notice of change, cannot otherwise be complied with, such notice shall be furnished at or before the time of filing the consolidated return.

(c) With respect to computations for years involved in the change to the consolidated basis, see § 23.32.

[T. D. 5127, 7 F. R. 1784]

§ 23.15 *Liability for tax*—(a) *Several liability of members of affiliated group.* Except as provided in paragraph (b) of this section, the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group.

(b) *Liability of a corporation in bankruptcy or receivership.* If, at the time of filing a consolidated return, one or more, but not all, of the members of the affiliated group are in bankruptcy under the laws of the United States or in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then the liability under paragraph (a) of this section of each such member of the group with respect to the period covered by such return shall not exceed such portion of the consolidated tax liability for such period as the several corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of such an agreement, an amount equal to its liability for

such year computed as if a separate return had been filed.

(c) *Liability of subsidiary after withdrawal.* If a subsidiary has ceased to be a member of the affiliated group, its liability under paragraph (a) of this section shall remain unchanged, except that if such cessation occurred prior to the date upon which any deficiency is assessed and resulted from a bona fide sale of stock for fair value, the Commissioner may, if he believes that the assessment or collection of the balance of the deficiency will not be jeopardized, make assessment and collection of such deficiency from such former subsidiary in an amount not exceeding the portion thereof allocable to it upon the bases of income used in the computations respectively of the normal tax and any surtaxes included in such deficiency.

(d) *Effect of intercompany agreements.* Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section.

(e) *Liability of transferee not affected.* This section shall not be considered as extinguishing or diminishing any liability, at law or in equity, of a transferee of property of a taxpayer, including any liability under any provision of law, State or Federal, relating to liabilities pursuant to corporate dissolution or transfer or distribution of assets, whether or not in connection with a merger or consolidation.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784]

§ 23.16 *Common parent corporation agent for subsidiaries*—(a) *Scope of agency of common parent corporation.* Except as provided in paragraphs (b) and (c) of this section:

(1) The common parent corporation shall be for all purposes, in respect of the tax for the taxable year for which a consolidated return is made or is required, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part of such year was a member of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each such corporation; notice and demand for payment of taxes will be given only to the common parent, and such notice and demand shall be considered as a notice and demand to each such corporation; the common parent will file petitions and conduct proceedings before the Board of Tax Appeals, and any such petition shall be considered as having also been filed by each such corporation; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such corporation; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such corporation. Notwithstanding the provisions of this subparagraph, however, any notice of deficiency, in respect of the tax for a consolidated return period, will name each corporation which was a member of the affiliated group during any part of such period, and any assessment (whether of the original tax or of a deficiency) will be made in the name of each such corporation (but a failure to include the name of any such corporation will not affect the validity of the notice of deficiency or the assessment as to the other corporations); any notice and demand for payment will name each corporation which was a member of the affiliated group during any part of such period (but a failure to include the name of any such corporation will not affect the validity of the notice and demand as to the other corporations); and any distraint (or warrant in respect thereof), any levy (or notice in respect thereof), any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this subparagraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time.

Notwithstanding the provisions of this subparagraph, the Commissioner may, if he deems it advisable, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

(b) *Effect of withdrawal of subsidiary.* For the purpose of the assertion, assessment, and collection of any deficiency, and of a credit or refund of any amount paid by a former subsidiary as a deficiency determined under § 23.15 (c), but for no other purpose, the agency of the common parent corporation in respect of any subsidiary which has ceased to be a member of the affiliated group shall be terminated upon the expiration of 30 days (or prior thereto if the Commissioner consents) from the date upon which such subsidiary files written notice with the Commissioner that it has ceased to be a member of the affiliated group and that it is terminating such agency. For example, if a subsidiary has ceased to be a member of the group (and if the 30-day period has expired) prior to the mailing of a notice of deficiency to the common parent, a separate notice of deficiency will be mailed in due course to the subsidiary in respect of its deficiency if it becomes necessary to enforce its liability.

(c) *Effect of dissolution of common parent corporation.* If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the Commissioner of such fact and designate, subject to the approval of the Commissioner, another member of the affiliated group to act as agent in its place, to the same extent and subject to the same conditions and limitations as are applicable to the common parent. If the notice thus required is not given by the common parent, the remaining members of the group may, subject to the approval of the Commissioner, designate another member of the group to act as such agent, and notice of such designation shall be given to the Commissioner. Until a notice in writing designating a new agent has been received by the Commissioner, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if the Commissioner has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly with any member of the group in respect of its liability.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283]

§ 23.17 *Waivers*—(a) *Effect of waiver given by common parent corporation.* Any consent given by the common parent corporation (or by an agent in accordance with § 23.16 (c)) extending the time within which an assessment may be made or distraint or proceeding in court begun, in respect of the tax for a consolidated return period, shall be applicable (1) to each corporation which was a member of the affiliated group during any part of such period (whether or not any such corporation has ceased to be a member of the group), and (2) to each corporation the income of which was included in the consolidated return, or which filed Form 1122, for such period, even though it is subsequently determined that such corporation was not a member of the group.

(b) *Acceptance of waivers from common parent corporation and alleged subsidiary.* In no case will a separate waiver be accepted from a corporation the income of which was included in the consolidated return (for example, a corporation which the Commissioner determines was not a member of the affiliated group), or which filed Form 1122, unless a waiver is also obtained from the common parent corporation, or unless the Commissioner is dealing directly with such corporation to enforce its liability.

[Regs. 104, 5 F. R. 7]

§ 23.18 *Failure to comply with regulations in this part*—(a) *Exclusion of a subsidiary from consolidated return.* If there has been a failure to include in the consolidated return the income of any subsidiary, or a failure to file any of the forms required by the regulations in this part, notice thereof shall be given the common parent corporation by the Commissioner, and the tax liability of each member of the affiliated group shall be determined on the basis of separate returns unless such income is included or such forms are filed within the period prescribed in such notice, or any extension thereof, or unless under § 23.11 a consolidated return is required for such year.

(b) *Common parent corporation incorrectly designated in consolidated re-*

turn. If a consolidated return includes a corporation as the common parent and such corporation was not (under the provisions of section 141) the common parent, the tax liability of each corporation included in the return will be computed in the same manner as if separate returns had been made, unless, upon application, the Commissioner approves the making of a consolidated return, or unless under § 23.11 a consolidated return is required for such year.

(c) *Inclusion of one or more subsidiaries not members of affiliated group.* If a consolidated return includes a corporation as a subsidiary and such corporation was not a member of the affiliated group during the consolidated return period, the tax liability of such corporation will be determined upon the basis of a separate return (but see paragraph (a) of this section), and the consolidated return shall be considered as including only the corporations which were members of the group during such period. If the consolidated return includes two or more corporations which are not members of the group but which constitute a separate affiliated group, the tax liability of the corporations constituting the separate group will be computed in the same manner as if separate returns had been made by such corporations, unless the Commissioner, upon application, approves the making of a consolidated return for the separate group, or unless under § 23.11 a consolidated return is required for the separate group.

(d) *Effect of authorization and consent filed pursuant to notice.* If Form 1122 is filed by any corporation, pursuant to a notice under paragraph (a) of this section, such corporation shall be considered for all purposes as having joined in the making of the consolidated return.

(e) *Allocation of payments in the event of change by one or more corporations to separate returns.* In any case in which amounts have been assessed and paid upon the basis of a consolidated return and the tax liability of one or more of the corporations included in the consolidated return is to be computed in the same manner as if separate returns had been made, the amounts so paid shall be allocated between the affiliated group composed of the corporations properly included in the consolidated return and each of the corporations the tax liability of which is to be computed on a separate basis, in such manner as the corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of an agreement, upon the bases used in the respective computations of the normal tax and any surtaxes as shown upon the consolidated return.

[Regs. 104, 5 F. R. 7]

§ 23.19 *Proceedings under Tax Adjustment Act of 1945*—(a) *General rule.* In the case of an affiliated group the membership of which remains unchanged and for which consolidated returns are made or required for the several taxable years involved, any statement filed under section 3779 of the Code with respect to an expected carry-back, any application for a tentative carry-back adjustment filed under section 3780, and any application for tentative adjustments with respect to amortization deductions filed under section 124 (j) shall be filed by the common parent corporation and shall disclose all material facts and circumstances relating to the group as a whole. Such statement or application shall be filed on the appropriate form prescribed for such purpose, Form 1138, 1139, or Form 1140, as the case may be. Any refunds allowable under any such application will be made directly to and in the name of the common parent. The making of any such refund will discharge any liability of the Government in respect thereof to the several affiliated corporations. The common parent corporation and its several subsidiaries shall be severally liable for any amounts assessed pursuant to section 3780 (b) or (c), 294 (e), or 124 (k), together with any interest or penalty assessed in connection therewith.

(b) *Groups with changing membership; cases involving separate return periods.* (1) The membership of an affiliated group may change during a taxable year for which a net operating loss or an unused excess profits credit arises; or during a taxable year in which an election is exercised to terminate the amortization period pursuant to section 124 (d) of the Code; or in prior taxable years affected by such net loss, unused credit, or election. Or an affiliated group making a consolidated return for the year of such net loss, unused credit, or election may have made separate returns for one or more of such prior years; or a group making separate returns for the year of the net loss, unused credit, or election may have made a consolidated

return for one or more of the prior fears. In any such case, the statement provided for in section 3779 (b) of the Code and the application for the tentative carry-back adjustment provided for in section 3780 (a) and the application for the tentative adjustment with respect to amortization deductions provided for in section 124 (j) shall be a joint statement or application concurred in and executed by each corporation which was a member of the group at any time during any of the several taxable years involved in the deferment or adjustment sought. The time for the payment of taxes shall be extended under section 3779 and the adjustments provided for in sections 3780 and 124 (k) shall be made only in accordance with an agreement of the several corporations involved to be made a part of such statement or application. Any refund allowable under any such application with respect to a consolidated return period will be made directly to and in the name of the common parent corporation, and the making of any such refund will discharge any liability of the Government in respect thereof to the several affiliated corporations. The common parent corporation and its several subsidiaries shall be severally liable for any amounts assessed pursuant to section 3780 (b) or (c), 294 (e), or 124 (k), together with any interest or penalty assessed in connection therewith.

(2) In the absence of an agreement between the several corporations, or in the event of their failure to set forth the provisions of such an agreement as a part of their statement or application, no extension of time for the payment of any tax under the provisions of section 3779 shall be granted, and no tentative adjustments shall be made under either section 3780 or section 124 (j) and (k).

(3) Notwithstanding any agreement between the several affiliated corporations, no tentative adjustment shall be made with respect to either a consolidated or a separate return period in disregard of the several liability of the several corporations with respect to any taxable year for which a consolidated return was made or was required.

[T. D. 5491, 11 F. R. 1091]

COMPUTATION OF TAX, RECOGNITION OF GAIN OR LOSS, AND BASIS

§ 23.30 *Computation of tax* — (a) *Years beginning prior to January 1, 1940.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year beginning prior to January 1, 1940, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed, in accordance with the provisions of section 13 of the Code prior to its amendment by section 201 of the Revenue Act of 1939, upon the basis of the consolidated adjusted net income if the consolidated net income is more than $25,000, or, in accordance with the provisions of section 14 of the Code prior to such amendment, upon the basis of the consolidated special class net income of the group if the consolidated net income is not more than $25,000; or, in the case of the taxes imposed by section 102 and by subchapter A, upon the basis of the consolidated undistributed section 102 net income or the consolidated undistributed subchapter A net income; such bases to be determined in accordance with §§ 23.30–23.44. (See, however, § 23.15, relating to the liability of the members of the group.)

(b) *Years beginning in 1940.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year beginning after December 31, 1939, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed upon the consolidated normal-tax net income of the group, or, in the case of the taxes imposed by section 102 and by subchapter A, the consolidated undistributed section 102 net income or the consolidated undistributed subchapter A net income, determined in accordance with §§ 23.30–23.44. (See, however, § 23.15, relating to the liability of the members of the group.)

(c) *Years beginning in 1941.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year beginning after December 31, 1940, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed upon the consolidated normal-tax net income and the consolidated corporation surtax net income of the group, or, in the case of the taxes imposed by section 102 and by subchapter A, the consolidated undistributed section 102 net income or the consolidated undistributed subchapter A net income, determined in each case in

accordance with §§ 23.30–23.44. (See, however, § 23.15, relating to the liability of the members of the group.)

(d) *Years beginning after December 31, 1941.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year beginning after December 31, 1941, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed upon the consolidated normal-tax net income and the consolidated corporation surtax net income of the group, or, in the case of the taxes imposed by section 102, section 201, and subchapter A, the consolidated undistributed section 102 net income, the consolidated adjusted normal-tax net income, and the consolidated adjusted corporation surtax net income, or the consolidated undistributed subchapter A net income, as the case may be, determined in each case in accordance with §§ 23.30–23.44. If the affiliated group filing the consolidated return includes a western hemisphere trade corporation, as defined in section 109, exempt from surtax pursuant to section 15 (b), the surtax of the group shall be an amount which bears the same ratio to the surtax computed on the consolidated corporation surtax net income as the portion of the consolidated corporation surtax net income attributable to the other members of the group bears to the entire consolidated corporation surtax net income. (See, however, § 23.15, relating to the liability of the members of the group.)

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283]

§ 23.31 *Bases of tax computation*—(a) *Definitions; years beginning prior to January 1, 1941*—(1) *In general.* In the case of an affiliated group of corporations which makes or is required to make a consolidated return for any taxable year beginning prior to January 1, 1941, and except as otherwise provided in this part;

(i) The consolidated net income shall be the combined net income of the several affiliated corporations, reduced, in the case of a taxable year beginning in 1940, by the consolidated net operating loss deduction;

(ii) The consolidated adjusted net income shall be the consolidated net income minus the combined credit of the several affiliated corporations provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

(iii) The consolidated credit for dividends received shall be an amount equal to the combined credit of the several affiliated corporations provided by section 26 (b) relating to dividends received, but not in excess of 85 percent of the consolidated adjusted net income;

(iv) The consolidated dividends, paid credit shall be the sum of:

(*a*) The consolidated basic surtax credit, and

(*b*) The consolidated dividend carry-over, and, for the purposes of section 13 of the Code prior to its amendment by section 201 of the Revenue Act of 1939,

(*c*) The consolidated deficit credit, and

(*d*) The consolidated credit relating to the payment or retirement of indebtedness;

(v) The consolidated basic surtax credit shall be the sum of:

(*a*) An amount equal to the sum of the dividends paid by the several affiliated corporations during the taxable year, increased by the consolidated consent dividends credit and reduced by the consolidated credit relating to interest on certain obligations of the United States and Government corporations, and

(*b*) The consolidated net operating loss credit;

(vi) The consolidated consent dividends credit shall be the combined consent dividends credits of the several affiliated corporations;

(vii) The consolidated credit relating to interest on certain obligations of the United States and Government corporations shall be an amount equal to the sum of such credits computed separately with respect to each of the several affiliated corporations;

(viii) The consolidated section 102 net income shall be the consolidated net income, computed without any net operating loss deductions, minus the sum of:

(*a*) The combined Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year by the several affiliated corporations to the extent not allowed as a deduction by section 23, but not including the tax imposed by section 102 of the Code, or a corresponding section of prior income-tax laws,

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(*b*) The combined contributions or gifts of the several affiliated corporations, payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) of the Code for the purposes therein specified, and

(*c*) The combined losses from sales or exchanges of capital assets which are disallowed to the several affiliated corporations as deductions by section 117 (d);

(ix) The consolidated undistributed section 102 net income shall be the consolidated section 102 net income minus the consolidated basic surtax credit, computed without reduction by the amount of the credit provided in section 26 (a), relating to interest on Government obligations;

(x) The consolidated subchapter A net income shall be the combined net income of the several affiliated corporations computed in the case of each corporation with the adjustments provided in section 505;

(xi) The consolidated undistributed subchapter A net income shall be the consolidated subchapter A net income minus the sum of:

(*a*) The consolidated dividends-paid credit computed with the exceptions and limitations provided in section 504 (a),

(*b*) The aggregate amounts, subject to the provisions of section 504 (b), used or irrevocably set aside by the several affiliated corporations to pay or to retire indebtedness incurred prior to January 1, 1934, not including such portion of any such indebtedness as was owned on January 1, 1934, or at any time thereafter, directly or indirectly by another member of the group, and

(*c*) The aggregate amount of dividends paid by the several affiliated corporations after the close of the taxable year, subject to the provisions of section 504 (c).

(2) *Years beginning in 1939.* In the case of an affiliated group of corporations which makes or is required to make a consolidated return for a taxable year beginning prior to January 1, 1940, and except as otherwise provided in the regulations in this part:

(i) The consolidated special class net income shall be the consolidated adjusted net income minus the consolidated credit for dividends received;

(ii) The consolidated deficit credit shall be an amount equal to the sum of the credits of the several affiliated corporations provided in section 27 (a) (3) relating to deficits in accumulated earnings and profits;

(iii) The consolidated credit relating to amounts used or irrevocably set aside to pay or to retire indebtedness shall be an amount equal to the sum of such credits computed separately with respect to each of the affiliated corporations;

(iv) The consolidated net operating loss credit shall be an amount equal to the consolidated net operating loss for the preceding taxable year, but not in excess of the consolidated adjusted net income for the taxable year;

(v) The consolidated net operating loss for the purposes of the consolidated net operating loss credit shall be an amount equal to the excess of the combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions and limitations provided in section 26 (c) (2) of the Code) over the combined net income (adjusted with respect to the exceptions and limitations provided in such subsection in connection with the computation of net operating losses) of the several affiliated corporations having net income; however, a net operating loss sustained by a corporation for a taxable year prior to the first taxable year in respect of which its income is included in the consolidated return of an affiliated group shall be included as a part of the consolidated net operating loss only to the extent that such net operating loss is not in excess of the adjusted net income of such corporation for such first taxable year computed without regard to the qualification expressed in paragraph (c) of this section relating to net operating loss deductions;

(vi) The consolidated dividend carryover, subject to the qualifications provided in section 27 (c) with respect to preceding taxable years beginning in 1936 and 1937, shall be the sum of:

(*a*) The amount of the consolidated basic surtax credit for the second preceding taxable year, reduced by the adjusted net income for such year, and further reduced by the amount, if any, by which the adjusted net income for the first preceding taxable year exceeds the sum of: The consolidated basic surtax credit for such year, and the excess, if

any, of the consolidated basic surtax credit for the third preceding taxable year over the consolidated adjusted net income for such year,

(*b*) The amount, if any, by which the consolidated basic surtax credit for the first preceding taxable year exceeds the consolidated adjusted net income for such year,

(*c*) For the first taxable year for which the income of a corporation is included in a consolidated return, the amount of any dividend carry-over to which such corporation would have been entitled if it had filed a separate return, and

(*d*) For the second taxable year for which the income of a corporation is included in a consolidated return, or is required to be so included, the amount of any dividend carry-over based upon dividend distributions made during its second preceding taxable year to which such corporation would have been entitled if it had continued to file separate returns, but only to the extent that such dividend distributions would have been a factor in the computation of the consolidated dividend carry-over of the affiliated group if such corporation had been a member of the group and its income had been included in a consolidated return of the group for the second preceding taxable year, and if the basic surtax credit and the adjusted net income of such corporation for the second preceding taxable year were the consolidated basic surtax credit and the consolidated adjusted net income of the group.

(3) *Years beginning in 1940.* In the case of an affiliated group of corporations which makes or is required to make a consolidated return for taxable years beginning after December 31, 1939, and before January 1, 1941, and except as otherwise provided in the regulations in this part:

(i) The consolidated normal-tax net income shall be the consolidated adjusted net income minus the consolidated credit for dividends received;

(ii) The consolidated net operating loss deduction shall be an amount equal to the consolidated net operating loss carry-over reduced by the amount, if any, by which the consolidated net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4) of section 122 of the Code as amended by section 211 of the Revenue Act of 1939) exceeds the consolidated normal-tax net income (computed without any net operating loss deduction);

(iii) The consolidated net operating loss carry-over shall be the sum of:

(*a*) The amount, if any, of the consolidated net operating loss for the first preceding taxable year, and

(*b*) The amount of the consolidated net operating loss, if any, for the second preceding taxable year reduced by the excess, if any, of the consolidated net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4) of section 122 of the Code as amended by section 211 of the Revenue Act of 1939) for the first preceding taxable year over the consolidated net operating loss for the third preceding taxable year;

(iv) The consolidated net operating loss for the purposes of the consolidated net operating loss deduction shall be an amount equal to the excess of the combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions and limitations provided in section 122 (d) of the Code as amended by section 211 of the Revenue Act of 1939) over the combined net income (adjusted with respect to the exceptions and limitations provided in such subsection in connection with the computation of net operating losses) of the several affiliated corporations having net income; however, a net operating loss sustained by a corporation for a taxable year prior to the first taxable year in respect of which its income is included in the consolidated return of an affiliated group shall be included as a part of the consolidated net operating loss only to the extent that:

(*a*) Such net operating loss for the first preceding taxable year is not in excess of the sum of the adjusted net income of such corporation for the first and second taxable years in respect of which its income is included in the consolidated return,

(*b*) The excess of such net operating loss for the second preceding taxable year over the net income, if any, of such corporation for the first preceding taxable year (computed without the benefit of any net operating loss deduction) is not in excess of the adjusted net income of such corporation for such first taxable year, or

(*c*) The sum of such net operating losses for the first and second preceding taxable years is not in excess of the sum of the adjusted net income of such corporation for such first and second taxable years;

(v) The consolidated net operating loss credit shall be an amount equal to the consolidated net operating loss for the preceding taxable year, but not in excess of, as the case may be:

(*a*) The consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or

(*b*) The consolidated subchapter A net income for the taxable year in the case of the tax imposed under subchapter A;

(vi) The consolidated net operating loss for the purposes of the consolidated net operating loss credit shall be an amount equal to the excess of the combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions and limitations provided in section 26 (c) (2) of the Code) over the combined net income (adjusted with respect to the exceptions and limitations provided in such subsection in connection with the computation of net operating losses) of the several affiliated corporations having net income; however, a net operating loss sustained by a corporation for a taxable year prior to the first taxable year in respect of which its income is included in the consolidated return of an affiliated group shall be included as a part of the consolidated net operating loss only to the extent that such net operating loss is not in excess of:

(*a*) That portion of the consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or

(*b*) That portion of the consolidated subchapter A net income for the taxable year in the case of the tax imposed by subchapter A,

as the case may be, attributable to such corporation for such first taxable year;

(vii) The consolidated dividend carry-over, subject to the qualifications provided in section 27 (c) with respect to a preceding taxable year beginning in 1937, shall be the sum of:

(*a*) The amount of the consolidated basic surtax credit for the second preceding taxable year, reduced by the consolidated subchapter A net income for such year, and further reduced by the amount, if any, by which the consolidated subchapter A net income for the first preceding taxable year exceeds the sum of: The consolidated basic surtax credit for such year, and the excess, if any, of the consolidated basic surtax credit for the third preceding taxable year over the consolidated subchapter A net income for such year.

(*b*) The amount, if any, by which the consolidated basic surtax credit for the first preceding taxable year exceeds the consolidated subchapter A net income for such year.

(*c*) For the first taxable year for which the income of a corporation is included in a consolidated return, the amount of any dividend carry-over to which such corporation would have been entitled if it had filed a separate return, and

(*d*) For the second taxable year for which the income of a corporation is included in a consolidated return, or is required to be so included, the amount of any dividend carry-over based upon dividend distributions made during its second preceding taxable year to which such corporation would have been entitled if it had continued to file separate returns, but only to the extent that such dividend distributions would have been a factor in the computation of the consolidated dividend carry-over of the affiliated group if such corporation had been a member of the group and its income had been included in a consolidated return of the group for the second preceding taxable year, and if the basic surtax credit and the subchapter A net income of such corporation for the second preceding taxable year were the consolidated basic surtax credit and the consolidated subchapter A net income of the group.

(b) *Definitions; years beginning after December 31, 1940*—(1) *Years beginning in 1941.* In the case of an affiliated group of corporations which makes, or is required to make, a consolidated return for any taxable year beginning after December 31, 1940, and before January 1, 1942, and except as otherwise provided in the regulations in this part:

(i) The consolidated net income shall be the combined net income of the several affiliated corporations:

(*a*) Minus any consolidated net operating loss deduction,

(*b*) Plus any consolidated net short-term capital gain, and

(*c*) Plus or minus, as the case may be, any consolidated net long-term capital gain or consolidated net long-term capital loss;

(ii) The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carry-overs and of the consolidated net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the consolidated net income (computed with the exceptions and limitations provided in section 122 (d), (1), (2), (3), and (4) exceeds the consolidated normal-tax net income (computed without any net operating loss deduction);

(iii) The consolidated net operating loss carry-overs to the taxable year shall consist of:

(*a*) The amount of the consolidated net operating loss, if any, for the first preceding taxable year,

(*b*) The amount of the consolidated net operating loss, if any, for the second preceding taxable year reduced by the consolidated net income, if any, for the first preceding taxable year computed with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a consolidated net operating loss deduction for such first preceding taxable year determined without regard to the net operating loss for such second preceding taxable year and without regard to any net operating loss carry-back,

and, with respect to net operating losses sustained by a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return,

(*c*) The amount of the net operating loss, if any, sustained by such corporation for the first preceding taxable year, and

(*d*) The amount of the net operating loss, if any, sustained by such corportation for the second preceding taxable year reduced by the net income, if any, of such corporation for the first preceding taxable year, or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced either by the net income of such corporation for such year increased with respect to its separate net short-term and long-term capital gains or by the consolidated net income for such year, whichever is the lesser, the net income for the first preceding taxable year being computed in each case with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction of such corporation or a consolidated net operating loss deduction, as the case may be, for such first preceding taxable year determined without regard to the net operating loss of such corporation for the second preceding taxable year and without regard to any net operating loss carry-back;

(iv) The consolidated net operating loss carry-backs to the taxable year shall consist of:

(*a*) The amount of the consolidated net operating loss, if any, for the first succeeding taxable year (to the extent not attributable to those corporations making separate returns in the taxable year) reduced to the extent absorbed as a carry-back by the net income, consolidated or separate, as the case may be, for the first preceding taxable year, such net income being computed with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction for such first preceding taxable year, consolidated or separate, as the case may be, determined without regard to the net operating loss for such first succeeding taxable year,

(*b*) The amount of the consolidated net operating loss, if any, for the second succeeding taxable year, to the extent not attributable to those corporations making separate returns in the taxable year,

and, with respect to net operating losses sustained by a corporation for taxable years subsequent to the last taxable year in respect of which its income is included in the consolidated return:

(*c*) The amount of the net operating loss, if any, sustained by such corporation for the first succeeding taxable year reduced by the net income, if any, of such corporation for the first preceding taxable year, or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced either by the net income of such corporation for such year increased with respect to its separate net short-term and long-term capital gains or by the consolidated net income for

such first preceding taxable year, whichever is the lesser, the net income for the first preceding taxable year being computed in either case with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction or a consolidated net operating loss deduction, as the case may be, for the first preceding taxable year determined without regard to the net operating loss of such corporation for the first succeeding taxable year, and

(*d*) The amount of the net operating loss, if any, sustained by such corporation for the second succeeding taxable year, not including as a first succeeding taxable year or a second succeeding taxable year any taxable year beginning prior to January 1, 1942, and not including as a first preceding taxable year any taxable year beginning prior to January 1, 1941;

(v) The consolidated net operating loss, computed for the purposes of the net operating loss deduction, shall be an amount equal to the excess of the combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions, additions, and limitations provided in section 122 (d) over the sum of:

(*a*) The combined net income of the several affiliated corporations having net income (adjusted with respect to the exceptions, additions, and limitations provided in section 122 (d) in connection with the computation of net operating losses), and

(*b*) The consolidated net short-term capital gains and the consolidated net long-term capital gains;

(vi) The consolidated net short-term capital gain shall be the excess of the sum of the short-term capital gains of the several affiliated corporations over the sum of:

(*a*) The aggregate short-term capital losses of such corporations, and

(*b*) The consolidated net short-term capital loss carry-over from the preceding taxable year;

(vii) The consolidated net short-term capital loss carry-over from the preceding taxable year (in an amount not greater than the consolidated net income for such year) shall be the excess of the sum of the short-term capital losses of the several affiliated corporations for the preceding taxable year over the sum of the short-term capital gains of such corporations;

(viii) The consolidated net long-term capital gain shall be the excess of the sum of the long-term capital gains of the several affiliated corporations over the sum of the long-term capital losses of such corporations;

(ix) The consolidated net long-term capital loss shall be the excess of the aggregate of the long-term capital losses of the several affiliated corporations over the aggregate of the long-term capital gains of such corporations;

(x) The consolidated normal-tax net income shall be the consolidated adjusted net income minus the consolidated section 26 (b) credit relating to dividends rceived;

(xi) The consolidated adjusted net income shall be the consolidated net income minus the consolidated section 26 (a) credit relating to interest on certain obligations of the United States and Government corporations;

(xii) The consolidated section 26 (a) credit relating to interest on certain obligations of the United States and Government corporations shall be an amount equal to the aggregate of the interest, of the class with respect to which credit is allowed by section 26 (a), received by the several affiliated corporations;

(xiii) The consolidated section 26 (b) credit relating to dividends received shall be an amount equal to 85 percent of the aggregate dividends, of the class with respect to which credit is allowed by section 26 (b), received by the several affiliated corporations, but not in excess of 85 percent of the consolidated adjusted net income;

(xiv) The consolidated corporation surtax net income shall be the consolidated net income minus the consolidated section 26 (b) credit for dividends received, computed by limiting such credit to 85 percent of the consolidated net income in lieu of 85 percent of the consolidated adjusted net income;

(xv) The consolidated section 102 net income shall be the consolidated net income computed without any net operating loss deduction, minus the sum of:

(*a*) The combined Federal income war-profits, and excess-profits taxes (other than a tax imposed by subchapter E of Chapter 2 of the Code for taxable years beginning after December 31, 1940)

paid or accrued during the taxable year by the several affiliated corporations, to the extent not allowed as a deduction by section 23, but not including a tax imposed by section 102 of the Code, or by a corresponding section of prior income tax laws,

(*b*) The combined contributions or gifts of the several affiliated corporations, payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) of the Code for the purposes therein specified, and

(*c*) The excess of the sum of the short-term capital losses of the several affiliated corporations over the sum of the short-term capital gains of such corporations;

(xvi) The consolidated undistributed section 102 net income shall be the consolidated section 102 net income minus the consolidated basic surtax credit;

(xvii) The consolidated subchapter A net income shall be the consolidated net income computed with the adjustments provided in section 505;

(xviii) The consolidated undistributed subchapter A net income shall be the consolidated subchapter A net income minus the sum of:

(*a*) The consolidated dividends paid credit with the exceptions and limitations provided in section 504 (a),

(*b*) The aggregate amount, subject to the provisions of section 504 (b), used or irrevocably set aside by the several affiliated corporations to pay or to retire indebtedness incurred prior to January 1, 1934, not including such portion of any such indebtedness as was owned on January 1, 1934, or at any time thereafter, directly or indirectly, by another member of the group,

(*c*) The aggregate amount of dividends paid by the several affiliated corporations after the close of the taxable year, subject to the provisions of section 504 (c), and

(*d*) The aggregate of the amounts, if any, distributed by the several affiliated corporations in redemption of preferred stock pursuant to the provisions of section 504 (d) of the Code as added by section 184 of the Revenue Act of 1942, not including any amounts so distributed with respect to preferred stock owned on January 1, 1934, or at any time thereafter, directly or indirectly, by another member of the group;

(xix) The consolidated dividends paid credit shall be the sum of:

(*a*) The consolidated basic surtax credit, and

(*b*) The consolidated dividend carry-over;

(xx) The consolidated basic surtax credit shall be the sum of:

(*a*) The aggregate amount of dividends paid by the several affiliated corporations during the taxable year (computed, in the case of the tax imposed by subchapter A, with the qualifications provided in section 504 (a) relating to dividends paid after the close of the taxable year),

(*b*) The combined consent dividends credit of the several affiliated corporations provided in section 28, and

(*c*) The consolidated net operating loss credit;

(xxi) The consolidated dividend carry-over for the taxable year shall be the sum of:

(*a*) The amount, if any, by which the consolidated basic surtax credit for the first preceding taxable year exceeds the consolidated subchapter A net income for such year,

(*b*) The amount of the consolidated basic surtax credit for the second preceding taxable year reduced by the consolidated subchapter A net income for such year and further reduced by the amount, if any, by which the consolidated subchapter A net income of the first preceding taxable year exceeds the sum of: The consolidated basic surtax credit for such year, and the excess, if any, of the consolidated basic surtax credit for the third preceding taxable year over the consolidated subchapter A net income for such year,

and, with respect to the unused basic surtax credit of a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return:

(*c*) The amount, if any, by which the basic surtax credit of such corporation for the first preceding taxable year exceeds the subchapter A net income of such corporation for such year, and

(*d*) The amount of the basic surtax credit of such corporation for the second preceding taxable year reduced by the subchapter A net income of such corporation for such year and further reduced by:

(*1*) The excess, if any, of the subchapter A net income of such corporation for the first preceding taxable year over the sum of: The basic surtax credit of such corporation for such year, and the amount, if any, by which the basic surtax credit of such corporation for the third preceding taxable year exceeds the subchapter A net income of such corporation for such year, or

(*2*) If the income of such corporation is included in the consolidated return for the first preceding taxable year, the lesser of the amount of the excess computed under (*1*) or the excess, if any, of the consolidated subchapter A net income for the first preceding taxable year over the sum of: The consolidated basic surtax credit of such corporation for such year, and the amount, if any, by which the basic surtax credit of such corporation for the third preceding taxable year exceeds the subchapter A net income of such corporation for such year;

(xxii) The consolidated net operating loss credit shall be an amount equal to the consolidated net operating loss for the preceding taxable year, but not in excess of, as the case may be:

(*a*) The consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or

(*b*) The consolidated subchapter A net income for the taxable year in the case of the tax imposed under subchapter A;

(xxiii) The consolidated net operating loss, computed for the purposes of the net operating loss credit, shall be the sum of:

(*a*) The excess of the sum of: The combined net operating losses of the several affiliated corporations having net operating losses, computed subject to the exceptions and limitations provided in section 26 (c) (2), and the consolidated net long-term capital loss, if any,

over the sum of: The combined net income, computed with respect to the exceptions and limitations provided in section 26 (c) (2), in connection with the computation of net operating losses, of the several affiliated corporations having net income, the consolidated net short-term capital gain, and the consolidated net long-term capital gain, if any, and

(*b*) With respect to the net operating loss sustained by a corporation for the taxable year prior to the first taxable year in respect of which its income is included in the consolidated return, the amount of such net operating loss for such prior taxable year, computed subject to the exceptions and limitations provided in section 26 (c) (2), in an amount not in excess of: That portion of the consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or that portion of the consolidated subchapter A net income for the taxable year in the case of the tax imposed under subchapter A, as the case may be, attributable to such corporation for the taxable year.

(2) *Years beginning after December 31, 1941.* In the case of an affiliated group of corporations which makes, or is required to make, a consolidated return for any taxable year beginning after December 31, 1941, and except as otherwise provided in this part:

(i) The consolidated net income shall be the combined net income of the several affiliated corporations:

(*a*) Minus the sum of:

(*1*) Any consolidated net operating loss deduction,

(*2*) Any consolidated net loss from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), and

(*3*) The aggregate amount of any contributions or gifts made by the several affiliated corporations during the taxable year, subject to the provisions of section 23 (q), but not in excess of 5 percent of the consolidated net income computed without regard to such contributions or gifts, and

(*b*) Plus any consolidated net capital gain, or

(*c*) Minus, in the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 204, the combined additional capital loss deductions of such corporations authorized by section 204 (c) (5) as amended by section 164 (c) of the Revenue Act of 1942, but in an amount not in excess of the consolidated net capital loss;

(ii) The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carry-overs and of the consolidated net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the consolidated net income (computed with the

exceptions and limitations provided in section 122 (d) (1), (2), (3), and (4) exceeds the consolidated normal-tax net income (computed without any net operating loss deduction and without the credit provided in section 26 (e), relating to income subject to excess profits tax);

(iii) The consolidated net operating loss carry-over to the taxable year shall consist of:

(*a*) The amount of the consolidated net operating loss, if any, for the first preceding taxable year, or, with respect to a first preceding taxable year beginning after December 31, 1941, the amount of the consolidated net operating loss for such year to the extent not attributable to those corporations making separate returns in the taxable year,

(*b*) The amount of the consolidated net operating loss, if any, for the second preceding taxable year (or, with respect to a second preceding taxable year beginning after December 31, 1941, the amount of the consolidated net operating loss for such year to the extent not attributable to those corporations making separate returns in the taxable year) reduced to the extent absorbed as a carry-over by the net income, consolidated or separate, as the case may be, for the first preceding taxable year (such net income being computed with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction for such first preceding taxable year, consolidated or separate, as the case may be, determined without regard to the net operating loss for such second preceding taxable year and without regard to any net operating loss carry-back), and, with respect to net operating losses sustained by a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return.

(*c*) The amount of the net operating loss, if any, sustained by such corporation for the first preceding taxable year, and

(*d*) The amount of the net operating loss, if any, sustained by such corporation for the second preceding taxable year reduced by the net income, if any, of such corporation for the first preceding taxable year, or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced either by the net income of such corporation for such year increased with respect to its separate net short-term and long-term capital gains (or for years beginning after December 31, 1941, its separate net capital gain) and increased or decreased, as the case may be, with respect to its separate gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j) or by the consolidated net income for such year, whichever is the lesser, the net income for the first preceding taxable year being computed in such case with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction or a consolidated net operating loss deduction, as the case may be, for such first preceding taxable year determined without regard to the net operating loss of such corporation for the second preceding taxable year and without regard to any net operating loss carry-back,

(iv) The consolidated net operating loss carry-backs to the taxable year shall consist of:

(*a*) The amount of the consolidated net operating loss, if any, for the first succeeding taxable year (to the extent not attributable to those corporations making separate returns in the taxable year) reduced to the extent absorbed as a carry-back by the net income, consolidated or separate, as the case may be, for the first preceding taxable year, such net income being computed with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction for such first preceding taxable year, consolidated or separate, as the case may be, determined without regard to the net operating loss for such first succeeding taxable year.

(*b*) The amount of the consolidated net operating loss, if any, for the second succeeding taxable year, to the extent not attributable to those corporations making separate returns in the taxable years,

and, with respect to net operating losses sustained by a corporation for taxable years subsequent to the last taxable year in respect of which its income is included in the consolidated return,

(*c*) The amount of the net operating loss, if any, sustained by such corporation for the first succeeding taxable year re-

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duced by the net income, if any, of such corporation for the first preceding taxable year, or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced either by the net income of such corporation for such year increased with respect to its separate net short-term and long-term capital gains (or, for years beginning after December 31, 1941, its separate net capital gain) and increased or decreased, as the case may be, with respect to its separate gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j) or by the consolidated net income for such first preceding taxable year, whichever is the lesser, the net income for the first preceding taxable year being computed in either case with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (4), and (6), and with a net operating loss deduction or a consolidated net operating loss deduction, as the case may be, for the first preceding taxable year determined without regard to the net operating loss of such corporation for the first succeeding taxable year, and

(*d*) The amount of the net operating loss, if any, sustained by such corporation for the second succeeding taxable year;

(v) The consolidated net operating loss, computed for the purposes of the net operating loss deduction, shall be an amount equal to the excess of the sum of:

(*a*) The combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions, additions, and limitations provided in section 122 (d)), and

(*b*) The consolidated net loss from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), over the sum of:

(*c*) The combined net income of the several affiliated corporations having net income (adjusted with respect to the exceptions, additions, and limitations provided in section 122 (d) in connection with the computation of net operating losses), and

(*d*) The consolidated net capital gain;

(vi) The consolidated net loss from involuntary conversions and from sales or exchanges of property subject to the provisions of section 177 (j) shall be the excess of the aggregate of the recognized losses of the character described in section 117 (j) sustained by the several affiliated corporations over the aggregate of the recognized gains of the character described in section 117 (j) realized by the several affiliated corporations;

(vii) The consolidated net capital gain shall be the excess of the sum of:

(*a*) The aggregate of the capital gains of the several affiliated corporations, and

(*b*) The consolidated net gain from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), over the sum of:

(*c*) The aggregate of the capital losses of such corporations, plus

(*d*) The aggregate of the consolidated net capital loss carry-overs to the taxable year, or

(*e*) In the first taxable year beginning after December 31, 1941, the consolidated net short-term capital loss carry-over from the last taxable year beginning in 1941;

(viii) The consolidated net gain from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j) shall be the excess of the aggregate of the recognized gains of the character described in section 117 (j) realized by the several affiliated corporations over the aggregate of the recognized losses of the character described in section 117 (j) sustained by the several affiliated corporations;

(ix) The consolidated net capital loss carry-overs to the taxable year shall consist of:

(*a*) The consolidated net capital losses, if any, for the five preceding taxable years (not including any taxable year beginning prior to January 1, 1942) to the extent that such losses were not attributable to corporations making separate returns in the taxable year, and were not absorbed by net capital gains for intervening taxable years pursuant to the provisions of section 117 (e) (1) of the Code as amended by section 150 of the Revenue Act of 1942, consolidated or separate, as the case may be,

and, with respect to net capital losses sustained by a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return,

(*b*) The net capital losses, if any, sustained by such corporation for its five preceding taxable years (not including any taxable year beginning prior to January 1, 1942) to the extent that such losses were not absorbed by the net capital gains of such corporation (or, if the income of such corporation is included in a consolidated return, by the consolidated net capital gains) for intervening taxable years pursuant to the provisions of section 117 (e) (1) of the Code as amended by section 150 of the Revenue Act of 1942;

(x) The consolidated net capital loss shall be the excess of the aggregate of the capital losses of the several affiliated corporations over the sum of:

(*a*) The aggregate of the capital gains of such corporations, and

(*b*) The consolidated net gain from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j),

reduced, in the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 204 but only for the purpose of net capital loss carry-over computations, by whichever of the following amounts is the lesser:

(*c*) The combined additional capital loss deductions of such corporations authorized by section 204 (c) (5) as amended by section 164 (c) of the Revenue Act of 1942, or

(*d*) The consolidated corporation surtax net income computed without regard to capital gains and losses;

(xi) The consolidated net short-term capital loss carry-over from the last taxable year beginning in 1941 (in an amount not greater than the consolidated net short-term capital gain of the taxable year) shall be the sum of:

(*a*) The consolidated net short-term capital loss, if any, for the last taxable year beginning in 1941 in an amount not in excess of the consolidated net income for such year, and

(*b*) With respect to a member of the group which filed a separate return for the last taxable year beginning in 1941, the net short-term capital loss, if any, of such corporation for such year in an amount not in excess of its net income for such year;

(xii) The consolidated net short-term capital gain shall be the excess of the aggregate of the short-term capital gains of the several affiliated corporations over the sum of:

(*a*) The aggregate short-term capital losses of such corporations, plus

(*b*) The consolidated net capital loss carry-overs to the taxable year, or

(*c*) In the first taxable year beginning after December 31, 1941, the consolidated net short-term capital loss carry-over from the last taxable year beginning in 1941;

(xiii) The consolidated net short-term capital loss shall be the excess of the aggregate of the short-term capital losses of the several affiliated corporations (or, for the purpose of the alternative tax computation under section 117 (c) as amended by section 150 (*c*) of the Revenue Act of 1942, the sum of such aggregate plus the consolidated net capital loss carry-over or the consolidated net short-term capital loss carry-over, as the case may be) over the aggregate of the short-term capital gains of such corporations;

(xiv) The consolidated net long-term capital gain shall be the excess of the sum of:

(*a*) The aggregate of the long-term capital gains of the several affiliated corporations, and

(*b*) The consolidated net gain from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), over the aggregate of the long-term capital losses of such corporations;

(xv) The consolidated normal-tax net income shall be the consolidated adjusted net income minus the sum of:

(*a*) The consolidated section 26 (e) credit relating to income subject to excess profits tax, and

(*b*) The consolidated section 26 (b) credit relating to dividends received;

(xvi) The consolidated adjusted net income shall be the consolidated net income minus the consolidated section 26 (a) credit relating to interest on certain obligations of the United States and Government corporations;

(xvii) The consolidated section 26 (a) credit relating to interest on certain obligations of the United States and Government corporations shall be an amount equal to the aggregate of the interest, of the class with respect to which credit is allowed by section 26 (a), received by the several affiliated corporations;

(xviii) The consolidated section 26 (b) credit relating to dividends received shall be an amount equal to 85 percent of the aggregate dividends, of the class with respect to which credit is allowed by section 26 (b), received by the several affiliated corporations, but in an amount not greater than 85 percent of the excess of the consolidated adjusted net income over the consolidated section 26 (e) credit relating to income subject to excess profits tax;

(xix) The consolidated section 26 (e) credit relating to income subject to excess profits tax shall be an amount equal to the consolidated adjusted excess profits net income as defined in Consolidated Excess Profits Tax Regulations 110, or, in the case of an affiliated group including as members one or more corporations subject to the provisions of section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the amount of which the consolidated excess profits tax is 90 percent for a taxable year beginning prior to January 1, 1944, or 95 percent for a taxable year begining after December 31, 1943, the consolidated excess profits tax for the purpose of this credit being computed without regard to the limitation provided in section 710 (a) (1) (B) (the 80 percent limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734;

(xx) The consolidated corporation surtax net income shall be the consolidated net income minus the sum of:

(*a*) The consolidated section 26 (e) credit relating to income subject to the excess profits tax, and

(*b*) The consolidated section 26 (b) credit for dividends received (computed by limiting such credit to 85 percent of the excess of the consolidated net income—in lieu of the consolidated adjusted net income—over the consolidated section 26 (e) credit, and computed without regard to dividends received on certain preferred stock of a public utility as referred to in (*c*) of this subdivision, and

(*c*) In the case of an affiliated group including as members one or more corporations which are public utilities as defined in section 26 (h) (2) (A) of the Code as added by section 133 of the Revenue Act of 1942, but in an amount not greater than that portion of the consolidated corporation surtax net income (computed without regard to this credit) attributable to such public utilities, the consolidated section 26 (h) credit relating to dividends paid by such public utilities on preferred stock as defined in section 26 (h) (2) (B) of the Code;

(xxi) The consolidated section 26 (h) credit relating to dividends paid by public utilities on preferred stock shall be an amount equal to the aggregate of the dividends paid by members of the affiliated group which are public utilities within the meaning of section 26 (h) (2) (A) on preferred stock within the meaning of section 26 (h) (2) (B);

(xxii) The consolidated section 102 net income shall be the consolidated net income, computed without regard to any capital loss carry-overs and without regard to any net operating loss deduction, minus the sum of:

(*a*) The combined Federal income, war-profits, and excess-profits taxes (other than a tax imposed by subchapter E of chapter 2 of the Code for taxable years beginning after December 31, 1940) paid or accrued during the taxable year by the several affiliated corporations, to the extent not allowed as a deduction by section 23, but not including the tax imposed by section 102 of the Code, or by a corresponding section of prior income tax laws,

(*b*) The combined contributions or gifts of the several affiliated corporations, payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (c) of the Code for the purposes therein specified.

(*c*) The excess of the sum of the capital losses of the several affiliated corporations (computed without regard to any capital loss carry-over) over the sum of the capital gains of such corporations, and

(*d*) The consolidated section 26 (e) credit relating to income subject to the excess profits tax;

(xxiii) The consolidated undistributed section 102 net income shall be the con-

solidated section 102 net income minus the consolidated basic surtax credit;

(xxiv) The consolidated subchapter A net income shall be the consolidated net income computed with the adjustments provided in section 505;

(xxv) The consolidated undistributed subchapter A net income shall be the consolidated subchapter A net income minus the sum of:

(*a*) The consolidated dividends paid credit with the exceptions and limitations provided in section 504 (a),

(*b*) The aggregate amount, subject to the provisions of Section 504 (b), used or irrevocably set aside by the several affiliated corporations to pay or to retire indebtedness incurred prior to January 1, 1934, not including such portion of any such indebtedness as was owned on January 1, 1934, or at any time thereafter, directly or indirectly, by another member of the group,

(*c*) The aggregate amount of dividends paid by the several affiliated corporations after the close of the taxable year, subject to the provisions of section 504 (c), and

(*d*) The aggregate of the amounts, if any, distributed by the several affilated corporations in redemption of preferred stock pursuant to the provisions of section 504 (d) of the Code as added by section 184 of the Revenue Act of 1942, not including any amounts so distributed with respect to preferred stock owned on January 1, 1934, or at any time thereafter, directly or indirectly, by another member of the group;

(xxvi) The consolidated dividends paid credit shall be the sum of:

(*a*) The consolidated basic surtax credit, and

(*b*) The consolidated dividend carry-over;

(xxvii) The consolidated basic surtax credit shall be the sum of:

(*a*) The excess of the aggregate amount of dividends paid by the several affiliated corporations during the taxable year (computed, in the case of the tax imposed by subchapter A, with the qualifications provided in section 504 (a) relating to dividends paid after the close of the taxable year) over the consolidated section 26 (h) credit relating to dividends paid by public utilities on certain preferred stock, and

(*b*) The combined consent dividends credit of the several affiliated corporations provided in section 28,

and, in an aggregate amount not exceeding the consolidated section 102 net income or the consolidated subchapter A net income, as the case may be, the sum of:

(*c*) The consolidated net operating loss credit, and

(*d*) In the case of an affiliated group including one or more holding company affiliates of a bank as defined in section 2 of the Banking Act of 1933, the consolidated section 26 (d) credit relating to earnings or profits devoted to the acquisition of readily marketable assets other than bank stock;

(xxviii) The consolidated dividend carry-over for the taxable year shall be the sum of:

(*a*) The amount, if any, by which the consolidated basic surtax credit for the first preceding taxable year exceeds the consolidated subchapter A net income for such year, or, with respect to a first preceding taxable year beginning after December 31, 1941, the excess of such credit over such income to the extent that such credit and such income are not attributable to corporations making separate returns in the taxable year,

(*b*) The amount of the consolidated basic surtax credit for the second preceding taxable year reduced by the consolidated subchapter A net income for such year and further reduced by the amount, if any, by which the consolidated subchapter A net income of the first preceding taxable year exceeds the sum of: The consolidated basic surtax credit for such year, and the excess, if any, of the consolidated basic surtax credit for the third preceding taxable year over the consolidated subchapter A net income for such year, or, with respect to a second preceding taxable year beginning after December 31, 1941, the amount of the consolidated basic surtax credit for such taxable year so reduced to the extent that any such basic surtax credit and any such subchapter A net income are not attributable to corporations making separate returns in the taxable year,

and, with respect to the unused basic surtax credit of a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return,

(*c*) The amount, if any, by which the basic surtax credit of such corporation for the first preceding taxable year exceeds the subchapter A net income of such corporation for such year, and

(*d*) The amount of the basic surtax credit of such corporation for the second preceding taxable year reduced by the subchapter A net income of such corporation for such year and further reduced by:

(*1*) The excess, if any, of the subchapter A net income of such corporation for the first preceding taxable year over the sum of: The basic surtax credit of such corporation for such year, and the amount, if any, by which the basic surtax credit of such corporation for the third preceding taxable year exceeds the subchapter A net income of such corporation for such year, or

(*2*) If the income of such corporation is included in the consolidated return for the first preceding taxable year, the lesser of the amount of the excess computed under (*1*) or the excess, if any, of the consolidated subchapter A net income for the first preceding taxable year over the sum of: The consolidated basic surtax credit of such corporation for such year, and the amount, if any, by which the basic surtax credit of such corporation for the third preceding taxable year exceeds the subchapter A net income of such corporation for such year;

(xxix) The consolidated net operating loss credit shall be an amount equal to the consolidated net operating loss for the preceding taxable year, or, with respect to a preceding taxable year beginning after December 31, 1941, the amount of the consolidated net operating loss for such year to the extent not attributable to those corporations making separate returns in the taxable year, but not in excess of, as the case may be,

(*a*) The consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or

(*b*) The consolidated subchapter A net income for the taxable year in the case of the tax imposed under subchapter A;

(xxx) The consolidated net operating loss, computed for the purposes of the net operating loss credit, shall be the sum of:

(*a*) The excess of the sum of:

(*1*) The combined net operating losses of the several affiliated corporations having net operating losses, computed subject to the exceptions and limitations provided in section 26 (c) (2),

(*2*) The consolidated net loss from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), and

(*3*) In the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 204, the combined additional capital loss deductions of such corporations authorized by section 204 (c) (5) as amended by section 164 (c) of the Revenue Act of 1942, over the sum of:

(*4*) The combined net income, computed with respect to the exceptions and limitations provided in section 26 (c) (2) in connection with the computation of net operating losses, of the several affiliated corporations having net income, and

(*5*) The consolidated net capital gain, and

(*b*) With respect to the net operating loss sustained by a corporation for the taxable year prior to the first taxable year in respect of which its income is included in the consolidated return, the amount of such net operating loss for such prior taxable year, computed subject to the exceptions and limitations provided in section 26 (c) (2), in an amount not in excess of: That portion of the consolidated section 102 net income for the taxable year in the case of the tax imposed by section 102, or that portion of the consolidated subchapter A net income for the taxable year in the case of the tax imposed under subchapter A, as the case may be, attributable to such corporation for the taxable year;

(xxxi) The consolidated section 26 (d) credit, relating to bank affiliates, shall be an amount equal to the aggregate of the earnings or profits of members of the group which are holding company affiliates of a bank as defined in section 2 of the Banking Act of 1933 devoted to the acquisition of readily marketable assets other than bank stock (not including any asset acquired, directly or indirectly, from another member of the group), subject, in the case of each such affiliate, to the limitations imposed by section 26 (d) determined without regard to the qualifications expressed in paragraph (d) (1) (ii) and (iii) of this section;

(xxxii) The consolidated adjusted normal-tax net income, in the case of an affiliated group consisting of corporations subject to the tax imposed by section 201, shall be the consolidated normal-tax net income minus the consolidated reserve and other policy liability credit provided in section 202 (b) and plus the consolidated adjustment for certain reserves provided in section 202 (c);

(xxxiii) The consolidated adjusted corporation surtax net income, in the case of an affiliated group consisting of corporations subject to the tax imposed by section 201, shall be the consolidated corporation surtax net income minus the consolidated reserve and other policy liability credit provided in section 202 (b) and plus the consolidated adjustment for certain reserves provided in section 202 (c);

(xxxiv) The consolidated reserve and other policy liability credit provided in section 202 (b) shall be the consolidated normal-tax net income multiplied by a figure to be determined and proclaimed by the Secretary for each taxable year pursuant to section 202 (b);

(xxxv) The consolidated adjustment for certain reserves provided in section 202 (c) shall be an amount equal to 3¼ percent of the combined unearned premiums and unpaid losses of the several affiliated corporations on contracts other than life insurance or annuity contracts, computed in the case of each corporation pursuant to the provisions of section 202 (c), but not less than 25 percent of the combined net premiums on such other contracts written during the taxable year.

(c) *Computations; years beginning prior to January 1, 1941.* (1) The net income of the several corporations shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations subject to the elimination of unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in this part as intercompany transactions), and without taking into account any net operating loss deduction. Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the term "net income" includes the case in which the allowable deductions of a member exceed its gross income.

(2) The adjusted net income, the dividends received credit provided by section 26 (b), the amount of dividends paid, the credit allowable pursuant to the provisions of section 28 relating to consent dividends, the credit provided by section 26 (a) relating to interest upon certain obligations of the United States and Government corporations, the net operating loss for the purposes of the credit as defined in section 26 (c) (2), the net operating loss for the purposes of the deduction as defined in section 122 (a), the credit provided by section 27 (a) (3) relating to deficits in accumulated earnings and profits, the credit provided by section 27 (a) (4) relating to amounts used or irrevocably set aside to pay or to retire indebtedness, and gains or losses from sales or exchanges of capital assets, shall be computed and determined in the case of each affiliated corporation in the same manner and subject to the same conditions as if a separate return were filed, except:

(i) The net income used in any such computation shall be the net income of the corporation determined in accordance with the provisions of this section;

(ii) In the computation of the net operating loss of the corporation, the provisions of this section pertaining to the determination of net income shall apply;

(iii) In the computation of the dividends received credit, there shall be excluded all dividends received from other members of the affiliated group;

(iv) In the computation of dividends paid, there shall be excluded all dividends paid by one member of the group to another;

(v) In the computation of the consent dividends credit, no amounts shall be included with respect to consents given by other members of the group;

(vi) In the case of any subsidiary, the credit provided by section 27 (a) (3) relating to deficits in accumulated earnings and profits shall not be greater than the excess of the adjusted net income of such subsidiary over its net operating loss credit;

(vii) The credit provided by section 27 (a) (4) relating to amounts used or

irrevocably set aside to pay or to retire indebtedness shall be computed in disregard of any such payment or setting aside to the extent that, on December 31, 1937, or at any time thereafter, such indebtedness was owned, directly or indirectly, by another member of the group; and

(viii) In the computation of gains or losses from sales or exchanges of capital assets, there shall be eliminated any gains or losses arising in intercompany transactions.

(d) *Computations; years beginning after December 31, 1940.* In the case of affiliated corporations which make, or are required to make, a consolidated return for a taxable year beginning after December 31, 1940, and except as otherwise provided in this part:

(1) The net income of such corporations shall be computed in accordance with the provisions covering the determination of net income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in this part as intercompany transactions).

(ii) No net operating loss deduction shall be taken into account,

(iii) No capital gains or losses shall be taken into account.

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the term "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceeds its gross income.

(iv) There shall be disregarded all gains and losses from involuntary conversions and from sales and exchanges of property subject to the provisions of section 117 (j),

(v) In the computation of the deduction under section 23 (v) relating to amortizable bond premium, there shall be disregarded the bonds of one member of the group owned by another member of the group during the taxable year. Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the term "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income,

(vi) In the computation of the net income of a corporation for the taxable year in which it became the common parent corporation of the affiliated group filing a consolidated return, the aggregate deductions of such corporation for such year otherwise allowable in excess of the gross income of such corporation for such year shall be excluded to the extent that such excess is attributable to that portion of such year preceding the date upon which such corporation became the common parent corporation of the group. Any amount excluded under this subdivision shall, to the extent that it constitutes a net operating loss within the provisions of section 122 or a net capital loss within the provisions of section 117, be considered as a net operating loss or a net capital loss, as the case may be, separately sustained by such corporation and subject to the provisions of paragraph (b) (2) (iii) (*c*) and (*d*) or paragraph (b) (2) (ix) (*b*) of this section,

(vii) In the case of a corporation which became a member of the affiliated group subsequent to March 14, 1941, common parent corporation or subsidiary, as the case may be, allowable deductions shall be determined subject to the qualifications prescribed in subparagraph (11) of this paragraph, and

(viii) No deduction under section 23 (q) with respect to charitable or other contributions shall be taken into account.

(2) For a taxable year for which a consolidated return is made or is required, the capital gains and losses, the short-term capital gains and losses, and the long-term capital gains and losses, as defined in section 117 (a), the gains and losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j), the additional capital loss deductions authorized by section 204 (c) (5), the interest received of a class with respect to which credit is allowed by section 26 (a), the dividends received of a class

with respect to which credit is allowed by section 26 (b), the net operating loss as defined in section 26 (c) (2) for the purpose of the net operating loss credit, the net operating loss as defined in section 122 (a) for the purpose of the net operating loss deduction, the earnings or profits devoted to the acquisition of readily marketable assets other than bank stock in the case of a bank affiliate within the provisions of section 26 (d), the dividends paid on the preferred stock of a public utility within the provisions of section 26 (h), the subchapter A net income, the Federal income, war-profits, and excess-profits taxes, the contributions or gifts of the class specified in section 23 (o) or 23 (q), the amounts used or irrevocably set aside to pay or to retire indebtedness incurred prior to January 1, 1934, the amount distributed in redemption of preferred stock pursuant to the provisions of section 504 (d), the basic surtax credit, the amount of dividends paid, and the consent dividends credit allowed pursuant to section 28 shall be computed and determined in the case of each affiliated corporation in the same manner and subject to the same conditions as if a separate return were filed, except:

(i) The net income used in any such computation shall be the net income of the corporation determined in accordance with the provisions of this section;

(ii) In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group;

(iii) Capital gains and losses, short-term capital gains and losses, long-term capital gains and losses, and the additional capital loss deduction authorized by section 204 (c) (5) shall be determined without regard to:

(*a*) Gains or losses arising in intercompany transactions,

(*b*) Gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j),

(*c*) The net capital loss carry-overs provided in section 117 (e) (1), and, in the first taxable year beginning after December 31, 1941, the net short-term capital loss carry-over provided in section 117 (e) (2), and

(*d*) In the case of a corporation which became a member of the affiliated group subsequent to March 14, 1941, common parent corporation or subsidiary, as the case may be, capital losses to the extent disallowed pursuant to the provisions of subparagraph (11) of this paragraph;

(iv) In the computation of the net operating loss as defined, either in section 26 (c) (2) or in section 122 (a), the provisions of this section pertaining to the determination of net income shall apply;

(v) In the computation of dividends paid, there shall be excluded all dividends paid by one member of the group to another;

(vi) In the computation of the consent dividends credit, no amounts shall be included with respect to consents given by other members of the group;

(vii) In the computation of the Federal income, war-profits, and excess-profits taxes, there shall be used the consolidated tax, or a proportionate part thereof, if the tax payable is properly computed on the basis of the consolidated return;

(viii) In the computation of dividends paid on the preferred stock of a public utility, there shall be excluded all dividends paid by such public utility to another member of the group; and

(ix) Gains and losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j) shall be determined without regard to:

(*a*) Gains or losses from intercompany transactions, and

(*b*) In the case of a corporation which became a member of the affiliated group subsequent to March 14, 1941, common parent corporation or subsidiary, as the case may be, such portion of any such loss as is disallowed pursuant to the provisions of subparagraph (11) of this paragraph.

(3) In no case (except as otherwise provided in this subparagraph) shall there be included in the consolidated net operating loss deduction for the taxable year as consolidated net operating loss carry-overs under paragraph (b) (1) (iii) (*c*) and (*d*), or paragraph (b) (2) (iii) (*c*) and (*d*) of this section, as the case may be, (relating to net operating losses sustained by a corporation in years prior to the first taxable year in respect of which its income is included in the consolidated return) and as consolidated net operating loss carry-backs under paragraph (b) (1) (iv) (*c*) and (*d*), or paragraph (b) (2) (iv) (*c*) and (*d*) of

this section, as the case may be, (relating to net operating losses sustained by a corporation in years subsequent to the last taxable year in respect of which its income is included in the consolidated return) an amount exceeding in the aggregate the net income of such corporation (computed with the exceptions and limitations provided in section 122 (d) (1), (2), (3), and (4)) included in the computation of the consolidated net income for the taxable year increased by its separate net capital gain (or, for years beginning prior to January 1, 1942, its separate net short-term and long-term capital gains) and increased or decreased, as the case may be with respect to its separate gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j). The provisions of this subparagraph do not apply with respect to that portion of any net operating loss carry-over from a taxable year beginning in 1941 attributable to war losses within the provisions of section 127 of the Code as added by section 156 of the Revenue Act of 1942, such portion being determined as the excess of the net operating loss for such year over the amount of any net operating loss for the year computed without regard to war losses.

(4) If a portion of the consolidated net operating loss deduction arises as a carry-over pursuant to the provisions of paragraph (b) (1) (iii) (*c*) or (*d*) or paragraph (b) (2) (iii) (*c*) or (*d*) of this section, as the case may be (relating to net operating losses sustained by a corporation in years prior to the first taxable year in respect of which its income is included in the consolidated return), or as a carry-back pursuant to the provisions of paragraph (b) (1) (iv) (*c*) or (*d*), or paragraph (b) (2) (iv) (*c*) or (*d*) of this section, as the case may be, (relating to net operating losses sustained by a corporation in years subsequent to the last taxable year in respect of which its income is included in the consolidated return), the consolidated net operating loss deduction shall not be less than the amount of such portion reduced by the amount, if any, by which the net income of such corporation (computed with the exceptions and limitations provided in section 122 (d) (1), (2), (3), and (4) exceeds the normal-tax net income of such corporation (computed, for taxable years beginning in 1941, without any net operating loss deduction but taking into account any net long-term capital loss, and, for taxable years beginning after December 31, 1941, without any net operating loss deduction and without the credit provided by section 26 (e) relating to income subject to excess profits tax but taking into account the additional capital loss deduction authorized by section 204 (c) (5), or, in the case of two or more such corporations, the sum of such portions so reduced.

(5) With respect to consolidated net operating loss carry-overs and carry-backs:

(i) If, in the computation of the consolidated net operating loss deduction for the second consolidated return period in respect of which the income of a corporation is included in the consolidated returns of the group, there is involved the net operating loss separately sustained by such corporation for the second preceding taxable year together with a consolidated net operating loss for the second preceding taxable year, or if, for the second consolidated return period in respect of which the income of two or more members of the group is included in the consolidated returns of the group, there are involved the net operating losses separately sustained by such corporations for the second preceding taxable year, no portion of the consolidated net income for the first preceding taxable year shall be taken into account more than once in giving effect to the provisions of paragraph (b) (1) (iii) (*b*) and (*d*), or (b) (2) (iii) (*b*) and (*d*) of this section, as the case may be, (relating to the computation of the consolidated net operating loss carry-overs attributable to losses of the second preceding taxable year);

(ii) If, in the computation of the consolidated net operating loss deduction for the last taxable year in respect of which the income of a corporation is included in the consolidated returns of the group, there is involved the net operating loss separately sustained by such corporation for the first succeeding taxable year together with a consolidated net operating loss for the first succeeding taxable year, or if, for the last taxable year in respect of which the income of two or more members of the group is included in the consolidated returns of the group, there are involved the net operating losses separately sustained by such corporations for the first succeeding taxable year, no portion of the con-

solidated net income for the first preceding taxable year shall be taken into account more than once in giving effect to the provisions of paragraph (b) (1) (iv) (*a*) and (*c*), or paragraph (b) (2) (iv) (*a*) and (*c*) of this section, as the case may be, (relating to the computation of the consolidated net operating loss carry-backs attributable to losses of the first succeeding taxable year).

(6) If, in the computation of the consolidated dividend carry-over for the second consolidated return period in respect of which the income of a corporation is included in the consolidated returns of the group, there is involved a separate unused basic surtax credit of such corporation for the second preceding taxable year together with a consolidated unused basic surtax credit for the second preceding taxable year, or if, for the second consolidated return period in respect of which the income of two or more members of the group is included in the consolidated returns of the group, there are involved the separate unused basic surtax credits of such corporations for the second preceding taxable year, no portion of the excess of the consolidated subchapter A net income over the consolidated basic surtax credit for the first preceding taxable year shall be taken into account more than once in giving effect to the provisions of paragraph (b) (1) (xxi) (*b*) and (*d*), or paragraph (b) (2) (xxvi) (*b*) and (*d*) of this section, as the case may be, (relating to the computation of that part of the consolidated dividend carry-over attributable to the unused basic surtax credits of the second preceding taxable year).

(7) If an affiliated group filing a consolidated return for a taxable year beginning after December 31, 1941, sustains a consolidated net operating loss within the provisions of section 26 (c), relating to the net operating loss credit, or within the provisions of section 122, relating to the net operating loss deduction, and if there are included as members of such group one or more corporations which made separate returns, either in a preceding taxable year (not including any year beginning prior to January 1, 1941) or in a succeeding taxable year, the portion of such consolidated net operating loss attributable to such corporations severally shall be determined, such portion in the case of any such corporation being determined in an amount proportionate to the net losses (capital net losses and ordinary net losses alike) of the several affiliated corporations having net losses, to the extent that such losses were taken into account in the computation of the consolidated net operating loss.

(8) If an affiliated group filing a consolidated return for a taxable year beginning after December 31, 1941, sustains a consolidated net capital loss, and if there are included as members of such group one or more corporations which make separate returns in a succeeding taxable year, the portion of such consolidated net capital loss attributable to such corporations severally shall be determined, such portion in the case of any such corporation being an amount which bears the same ratio to the consolidated net capital loss which the net capital loss of such corporation bears to the aggregate of the net capital losses for the taxable year sustained by the several affiliated corporations having net capital losses.

(9) If an affiliated group filing a consolidated return for a taxable year beginning after December 31, 1941, has an unused consolidated basic surtax credit, and if there are included as members of such group one or more corporations which make separate returns in a succeeding taxable year, the portion of such unused consolidated basic surtax credit attributable to such corporations severally shall be determined for the purposes of the dividend carry-over, such portion in the case of any such corporation being determined in an amount proportionate to the dividends paid, the consent dividends credits, the several factors involved in the computation of the consolidated net operating loss credit, and the subchapter A net incomes of the several affiliated corporations, to the extent that such items were taken into account in the computation of the consolidated basic surtax credit and the consolidated subchapter A net income.

(10) In no case shall there be included in the computation of the consolidated net capital gain for the taxable year as a consolidated net capital loss carry-over under paragraph (b) (2) (ix) (*b*) of this section (relating to net capital losses sustained by a corporation in years prior to the first taxable year in respect of which its income is included in the consolidated return) an amount exceeding

in the aggregate the net capital gains of such corporation (determined without regard to any net capital loss carry-over) included in the computation of the consolidated net capital gain for the taxable year increased with respect to its separate net gains from involuntary conversions and from sales or exchanges of property subject to the provisions of section 117 (j).

(11) In the case of an affiliated group formed at any time subsequent to March 14, 1941, or having among its members in the taxable year one or more subsidiaries which became members of the group subsequent to March 14, 1941, the consolidated net income for the taxable year, and for prior and subsequent taxable years to the extent affected by carrybacks and carry-overs from the taxable year, shall be determined subject to the following qualifications:

(i) There shall be excluded in the case of the common parent corporation and in the case of any subsidiaries which were members of the group on March 14, 1941, those deductions from gross income otherwise allowable with respect to:

(*a*) Sales or exchanges of capital assets,

(*b*) Involuntary conversions and sales or exchanges of property subject to the provisions of section 117 (j),

(*c*) Securities subject to the provisions of section 23 (g) (4) or sections 23 (k) (5), or

(*d*) Debts subject to the provisions of section 23 (k) (1).

to the extent that such deductions otherwise allowable exceed in the aggregate:

(*1*) In the case of capital losses, the excess of the aggregate capital gains over the aggregate capital losses of such corporations for the taxable year, or

(*2*) In the case of ordinary losses, the aggregate of the ordinary net income of such corporations for the taxable year, increased in an amount equal to any excess of aggregate capital gains over aggregate capital losses of such corporations,

such capital gains and losses and such ordinary net income being determined pursuant to the provisions of these regulations but without regard to the provisions of paragraph (d) (1) (iv) and paragraph (d) (2) (iii) (*b*) of this section and without regard to the losses in question:

(ii) There shall be excluded in the case of a subsidiary corporation which became a member of the affiliated group subsequent to March 14, 1941, those deductions from gross income otherwise allowable with respect to:

(*a*) Sales or exchanges of capital assets,

(*b*) Involuntary conversions and sales or exchanges of property subject to the provisions of section 117 (j),

(*c*) Securities subject to the provisions of section 23 (g) (4) or section 23 (k) (5), or

(*d*) Debts subject to the provisions of section 23 (k) (1), to the extent that such deductions otherwise allowable are attributable to events preceding the date upon which such corporation became a member of the group, and

(*1*) Being capital losses, exceed:

(*i*) The capital gains reduced by all other capital losses of such corporation for the taxable year, in the case in which such corporation was not, on March 14, 1941, a member of an affiliated group within the meaning of section 141, or

(*ii*) In case such corporation was a member of an affiliated group on March 14, 1941, an amount which, together with like losses computed subject to the provisions of this part in the case of other members of the group during the taxable year which were affiliated with such corporation on March 14, 1941, within the meaning of section 141, is equal to the aggregate capital gains reduced by the aggregate of all other capital losses of such corporation and of such other members of the group, or

(2) Being ordinary losses, exceed:

(*i*) The ordinary net income of such corporation for the taxable year increased in an amount equal to any excess of capital gains over capital losses for the taxable year, in the case in which such corporation was not, on March 14, 1941, a member of an affiliated group within the meaning of section 141, or

(*ii*) In case such corporation was a member of an affiliated group on March 14, 1941, an amount which, together with like losses computed subject to the provisions of this part in the case of other members of the group during the taxable year which were affiliated with such corporation on March 14, 1941 within the meaning of section 141, is equal to the ordinary net income of such

corporation for the taxable year increased by the aggregate of the ordinary net income and decreased by the aggregate of the ordinary net losses of other members of the affiliated group during the taxable year which were affiliated with such corporation on March 14, 1941, within the meaning of section 141, and increased further in an amount equal to any excess of aggregate capital gains over aggregate capital losses of such corporations,

such capital gains and losses, and ordinary net income and net losses, as the case may be, being determined pursuant to the provisions of this part but without regard to the provisions of paragraphs (d) (1) (iv) and (d) (2) (iii) (*b*) of this section and without regard to the losses in question;

(iii) The portion of any loss otherwise allowable as a deduction for the taxable year which is disallowed pursuant to the provisions of subdivisions (i) and (ii) of this subparagraph shall, to the extent that it constitutes a net capital loss within the provisions of section 117 or a net operating loss within the provisions of section 122, be considered as a net capital loss or a net operating loss, as the case may be, in respect of those members of the group by reference to which the amount of the deduction disallowed under subdivisions (i) and (ii) of this subparagraph was determined, originating, for the purpose of the carry-back provisions, in a taxable year subsequent to the last taxable year in respect of which their income was included in a consolidated return, and, for the purpose of the carry-over provisions, in a taxable year prior to the first taxable year in respect of which their income was included in a consolidated return;

(iv) The provisions of subdivisions (i) and (ii) of this subparagraph shall not apply with respect to the common parent corporation of an affiliated group formed subsequent to March 14, 1941, or to the common parent corporation or subsidiaries of a group in existence on March 14, 1941, acquiring new members subsequent to March 14, 1941, or with respect to subsidiaries becoming members of the group subsequent to March 14, 1941:

(*a*) If the group consists solely of the common parent corporation and one or more subsidiaries created, directly or indirectly, by the common parent corporation or by other members of the group;

(*b*) If, immediately after the corporation involved became a member of the group, common parent corporation or subsidiary, as the case may be, stock possessing at least 95 percent of the voting power of all classes of its stock then outtanding and at least 95 percent of each class of its nonvoting stock then outstanding is owned, directly or indirectly, by substantially the same interests by which such stock was owned on March 14, 1941;

(*c*) If the affiliated group involved was formed, or the new subsidiary became a member of the group, as an incident to an involuntary conversion or to a transfer made pursuant to an order of the Securities and Exchange Commission, the Federal Communications Commission, the Interstate Commerce Commission, or a similar regulatory body of State or Federal Government; or

(*d*) To the extent to which, upon consideration of the facts or circumstances presented by the particular case, the Commissioner determines that a consolidated net income computed with respect to the affiliated group but without regard to those subdivisions will not serve to distort the income tax liability of the group or of any of its members.

(e) *Statements and schedules for subsidiaries.* The statement of gross income and deductions and the several schedules required by the instructions on the return must be prepared and filed by the common parent corporation in columnar form so that the details of the items of gross income, deductions, and credits, for each member of the affiliated group, may be readily audited. Such statements and schedules shall include in columnar form a reconciliation of surplus for each such corporation, together with a reconciliation of the consilidated surplus. Consolidated balance sheets as of the beginning and close of the taxable year of the group, taken from the books of the members of the group, shall accompany the consolidated return prepared in a form similar to that required for reconciliation of surplus.

(f) *Net operating loss deduction, net operating loss credit, and dividend carry-over after consolidated return period.* (1) The consolidated net operating loss (whether computed for the purpose of the deduction or the credit) or the unused consolidated basic surtax credit of an affiliated group for any consolidated

return period beginning prior to January 1, 1942, shall be used in computing the net operating loss deduction, the net operating loss credit, or the dividend carry-over, as the case may be, in the return of the common parent corporation (or the consolidated net operating loss deduction, the consolidated net operating loss credit, or the consolidated dividend carry-over in the consolidated return of another affiliated group of which such common parent becomes a member) for a taxable year subsequent to the last consolidated return period of the group in the same manner, to the same extent, upon the same conditions, and subject to the same limitations as if, during the taxable year in which such loss or such unused basic surtax credit originated and continuing to the date of the termination of the group, the group had been a single corporation, the common parent corporation; and no net operating loss or unused basic surtax credit attributable to a consolidated return period beginning prior to January 1, 1942, shall be used in computing the net operating loss deduction, the net operating loss credit, or the dividend carry-over of a subsidiary (or the consolidated net operating loss deduction, the consolidated net operating loss credit, or the consolidated dividend carry-over of another affiliated group of which such subsidiary becomes a member) for any taxable year subsequent to the last consolidated return period of the group. No part of any unused basic surtax credit of a corporation for a year prior to the first taxable year in respect of which its income is included in the consolidated return, if the consolidated return year begins prior to January 1, 1942, shall be used in computing the dividend carry-over of such corporation (or the consolidated dividend carry-over of another affiliated group of which it becomes a member) for any taxable year subsequent to the last consolidated return period, but any part of such unused basic surtax credit which, except for this restriction, might be so used shall be treated as attributable to the common parent corporation of the group for a year in which such common parent had no adjusted net income and no other basic surtax credit. No part of any net operating loss sustained by a corporation prior to the first taxable year in respect of which its income is included in the consolidated return, if the consolidated return year begins prior to January 1, 1942, shall be used in computing the net operating loss deduction of such corporation (or the consolidated net operating loss deduction of another affiliated group of which it becomes a member) for any taxable year subsequent to the last consolidated return period, but any part of such net operating loss which, except for this restriction, might be so used shall be treated as having been sustained by the common parent corporation of the group.

(2) The consolidated net operating loss (whether computed for the purpose of the deduction or the credit) of an affiliated group for a consolidated return period beginning after December 31, 1941, or the unused consolidated basic surtax credit of such group for such period, shall be used in computing the consolidated net operating loss deduction, the consolidated net operating loss credit, or the consolidated dividend carry-over, as the case may be, notwithstanding that one or more corporations, members of the group in the taxable year in which such loss or such unused basic surtax credit originates, make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year (or, in the case of a carry-back computation, for a preceding taxable year), but only to the extent that such consolidated net operating loss or such unused consolidated basic surtax credit is not attributable to such corporations; and such portion of such consolidated net operating loss or such unused consolidated basic surtax credit as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year (or, in the case of a carry-back computation, for a preceding taxable year) shall be used by such corporations severally as carry-over, or as carry-backs, in such separate returns, or in such consolidated return, of the other affiliated group. Any unused basic surtax credit of a corporation for a year prior to the first taxable year in respect of which its income is included in the consolidated return, if the consolidated return year begins after December 31, 1941, shall be used in computing the dividend carry-over of such corporation (or the consolidated dividend carry-over of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consoli-

dated return of another group, but only to the extent that such unused basic surtax credit was not absorbed in the computation of the consolidated dividend paid credit for the prior consolidated return period. Any net operating loss sustained by a corporation prior to the first taxable years in respect of which its income is included in the consolidated return, if the consolidated return year begins after December 31, 1941, shall be used in computing the net operating loss deduction of such corporation (or the consolidated net operating loss deduction of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such net operating loss was not absorbed in the computation of the consolidated net operating loss deduction for the prior consolidated return period.

(g) *Taxable year.* Any period of less than 12 months for which either a separate return or a consolidated return is filed, under the provisions of § 23.13, shall be considered as a taxable year.

(h) *Carry-backs from taxable years beginning after December 31, 1945.* To the extent that it may become necessary under section 122 (b) of the Revenue Act of 1945 to determine a net operating loss for a taxable year beginning after December 31, 1945, or to determine an unused excess profits credit for any such year, for the purpose of the excess profits tax provisions of subchapter E of chapter 2, any such determination in the case of an affiliated group shall be made in all respects as if a consolidated return for such year, subject to the provisions of Part 33 (26 CFR 1943 Cum. Supp., Supps.) were made or were required, if a consolidated income tax return for such year is made or is required under the provisions of this part. If separate income tax returns are properly filed for any such year, the required excess profits tax determinations shall be made as if separate excess profits tax returns were properly filed for such year, regardless of the fact that consolidated returns may have been filed for taxable years beginning prior to January 1, 1946.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283, T. D. 5340, 9 F. R. 2843, T. D. 5341, 9 F. R. 2844, T. D. 5397, 9 F. R. 9883, T. D. 5476, 10 F. R. 11698]

§ 23.32 *Method of computation of income for period of less than 12 months.* If a corporation, during the taxable year of the group, becomes a member or ceases to be a member of an affiliated group which makes or is required to make a consolidated return for such year, the income of such corporation to be included in the consolidated return shall be computed on the basis of its income as shown by its books if the accounts are so kept that the income for the period during which it is a member of the group can be clearly and accurately determined. If the accounts are not so kept, the income to be included in the consolidated return shall be computed on the basis of that proportion of its income (subject to the elimination of items exempt from taxation and the addition of items not allowable as deductions in computing net income) for the full period covered by its books which the number of days for which its income is included in the consolidated return bears to the number of days in the full period covered by its books; but in the discretion of the Commissioner there may be eliminated before the proration is made items of income or deduction clearly and accurately determined to be attributable to particular periods, and, after the proration is made, such eliminated items will be added to (if items of income) or deducted from (if deductible items) the income determined by proration for the period to which such items are applicable. The credits allowable under sections 13 and 14 of the Code prior to its amendment by section 201 of the Revenue Act of 1939, and under section 13 of the Code as amended shall be given for the period to which they are properly applicable under the facts in the case.

[Regs. 104, 5 F. R. 7]

§ 23.33 *Gain or loss from sale of stock, or bonds or other obligations.* Gain or loss from the sale or other disposition (whether or not during a consolidated return period), by a corporation which during any period of time (included in a taxable year beginning after December 31, 1938) has been a member of an affiliated group which makes or is required to make a consolidated return, of any share of stock or any bond or obligation issued or incurred by another corporation which during any part of such period was a member of the same group, shall be determined, and the extent to which such gain or loss shall be

recognized and shall be taken into account shall also be determined, in the same manner, to the same extent, and upon the same conditions as though such corporations had never been affiliated (see sections 111 to 115, inclusive, and section 117, and the regulations thereunder), except:

(a) In the case of a disposition (by sale, or in complete or partial liquidation not involving cash in an amount in excess of the adjusted basis of both the stock and the bonds and other indebtedness liquidated, or otherwise) during a consolidated return period to another member of the group (see §§ 23.31 and 23.37); and

(b) That the basis for determining the gain or loss, in the case of shares of stock, or in the case of bonds or other obligations, held during any part of a consolidated return period, shall be determined in accordance with §§ 23.34 and 23.35; and

(c) As provided in § 23.36 (imposing certain limitations upon losses otherwise allowable upon sales of stock, or bonds or other obligations).

[Regs. 104, 5 F. R. 7, as amended by T. D. 5441, 10 F. R. 2425]

§ 23.34 *Sale of stock; basis for determining gain or loss*—(a) *Scope of section.* This section prescribes the basis for determining the gain or loss upon any sale or other disposition (referred to as "sale" in this section) by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for any taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations in this part.

(1) For the basis in the case of a sale which does not break the affiliation and which is made during a taxable year for which a return is required to be filed on or before March 1, 1945, see paragraph (b) of this section.

(2) For the basis in the case of a sale which does not break the affiliation and which is made during a taxable year for which a return is required to be filed after March 1, 1945, and in the case of a sale made at any time which breaks the affiliation, see paragraph (c) of this section.

(3) For the basis in the case of a sale made after the selling corporation has ceased to be a member of the affiliated group, see paragraph (d) of this section.

(4) For the basis in the case of a sale of bonds see § 23.35.

(b) *Sales made during taxable year for which return required on or before March 1, 1945, which do not break affiliation.* (1) With respect to a sale made during a taxable year for which the last day prescribed by law for the filing of a return fell on or before March 1, 1945, the date on which the Treasury Decision 5441 (10 F. R. 2425) was filed with the Division of the Federal Register, if, notwithstanding such sale, the issuing corporation remains a member of the affiliated group, the basis shall be determined and adjusted in the same manner as if the selling corporation and the issuing corporation had never been members of an affiliated group.

(2) But see § 23.38 (b), relating to intercompany transactions.

(c) *Sales made during taxable year for which return required after March 1, 1945, which do not break affiliation; and sales made at any time which break affiliation.* If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group (not including sales made during a taxable year for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945, if such sale did not break the affiliation), the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale shall be determined separately for each member of the group and adjusted in accordance with the Code, but without regard to any adjustment under the last sentence of section 113 (a) (11) relating to losses of the issuing corporation sustained by such corporation after it became a member of the affiliated group.

(2) From the combined aggregate bases as determined in subparagraph (1) of

this paragraph, there shall be deducted the sum of the losses of such issuing corporation sustained during taxable years for which consolidated income tax return were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss or net operating loss in computing its net income for such taxable years if it had made a separate return for each of such years, reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this paragraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year;

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under subparagraph (2) of this paragraph, shall then be apportioned among the members of the affiliated group which hold stock of the issuing corporation, by allocating to each such member that proportion of the sum of the aggregate basis so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases;

(4) The aggregate basis as determined under subparagraph (3) of this paragraph for each member of the affiliated group shall then be equitably apportioned among the several classes of stock of the issuing corporation held by such member according to the circumstances of the case—ordinarily by allocating to each class of such stock that proportion of the aggregate basis which the basis of each class of such stock held by it at the time of the sale is to the sum of the bases of the several classes of such stock held by it;

(5) The basis of each share of stock of each class held by a member of the affiliated group shall then be determined by dividing the basis apportioned to such class under suparagraph (4) of this subparagraph by the total number of shares of such class held by it.

APPLICATION OF PARAGRAPH (C) (2)

Corporations P and S are affiliated and make consolidated returns showing the following gains and losses (losses indicated by parentheses):

Year	P	S	Consolidated
1929	($10,000)	($20,000)	($30,000)
1930	15,000	(18,000)	(3,000)
1931	13,000	(10,000)	3,000
1932	12,000	8,000	20,000
1933	8,000	(4,000)	4,000
1934	10,000	(20,000)	(10,000)
1935	20,000	30,000	50,000
1936	10,000	20,000	30,000
1937	10,000	(5,000)	5,000
1938	20,000	(30,000)	(10,000)

On January 1, 1939, P sells the stock of S. The adjustment to be made to the basis of the stock for losses sustained by S during the consolidated return periods is $58,000, computed as follows:

Year of loss	Amount of loss	Extent separately available to S as net loss deduction	Reduction of adjustment by reason of consolidated loss	Adjustment under par. (c) (2)
1929	$20,000	$0	$18,000	$2,000
1930	18,000	0	3,000	15,000
1931	10,000	8,000	0	2,000
1933	4,000	0	0	4,000
1934	20,000	0	10,000	10,000
1937	5,000	0	0	5,000
1938	30,000	0	10,000	20,000
	107,000	8,000	41,000	58,000

APPLICATION OF PARAGRAPH (C) (3)

Corporations P, S_1, and S_2, are affiliated and make consolidated calendar year returns for 1937, 1938, and 1939. The aggregate bases of the stocks of the affiliated corporations in the hands of the members of the affiliated groups are as follows:

	Common	Percent
Aggregate basis of S_1 stock in the hands of P	$100,000	100
Aggregate basis of S_2 stock in the hands of P	50,000	50
Aggregate basis of S_2 stock in the hands of S_1	50,000	50

On January 1, 1940, P sells its stock in S_2. The sum of the aggregate bases of the stock of S_2 in the hands of P and S_1 is $100,000. Assuming that the adjustment under paragraph (c) (2) is $20,000, such sum is reduced to $80,000. This sum ($80,000) is apportioned between P and S_1 by allocating to each corporation $40,000, that is, that proportion of the $80,000 which the aggregate basis of S_2 stock in the hands of each corportation ($50,000) bears to the sum of the aggregate bases ($100,000). Accordingly, the basis for determining gain or loss from the sale of S_2 stock by P is $40,000.

(d) *Sales after selling corporation has ceased to be member of affiliated group.* If the sale is made after the selling corporation has ceased to be a member of the affiliated group, such basis shall be determined in accordance with paragraph (c) of this section, except that:

(1) The aggregate basis (under paragraph (c) (1) of this section) shall be determined for all shares of the issuing corporation held by each member of the group immediately prior to the time the selling corporation ceased to be a member of the group (rather than immediately prior to the sale);

(2) The reduction (under paragraph (c) (2) of this section) with respect to losses apportioned to stock sold or otherwise disposed of in prior transactions shall be determined without regard to the transaction which terminated the affiliation and all subsequent transactions.

(3) The allocations (under paragraph (c) (3) of this section) shall be made to each member of the group which held stock of the issuing corporation immediately prior to the time the selling corporation ceased to be a member of the group (rather than to the members holding such stock at the time of the sale); and

(4) The basis of each share of stock held by the selling corporation (determined, as above, as of the time the selling corporation ceased to be a member of the group) shall then be adjusted in accordance with the Code (see, particularly, sections 111 to 115, inclusive), in order to determine the basis at the time of the sale.

(e) *Definition of "loss," "consolidated loss," and "net loss" or "net operating loss."* As used in this section the term "loss" means the excess over the gross income of the issuing corporation of the sum of its allowable deductions (not including any net loss or net operating loss deduction) plus the proportionate part properly attributable to such corporation of the credits relating to interest on certain Government obligations and dividends received allowable in computing consolidated normal-tax net income, the consolidated special class net income, or consolidated net income subject to tax; the term "consolidated loss" means the excess of the sum of the losses, separately computed, over the sum of the normal-tax net income, the special class net income, or the net income subject to tax, separately computed, of the several members of the affiliated group, determined in accordance with the provisions of the Code, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations, applicable to the period; and the term "net loss" or "net operating loss" means the net loss or net operating loss, as the case may be, determined in accordance with the provisions of the Code, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations, applicable to the period.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 8283, T. D. 5441, 10 F. R. 2425]

§ 23.35 *Sale of bonds or other obligations; basis for determining gain or loss.* In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax return for any taxable year, of bonds or other obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during, or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined in accordance with the Code, but without regard to any adjustment under the last sentence of section 113 (a) (11), shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (c) (2) or (d) of § 23.34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (c) (1) or (d) of this section, as the case may be, held by the members of the group. The adjustment with respect to

so much of such deductions as is based upon losses sustained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945, the date on which Treasury Decision 5441 (10 F. R. 2425) was filed with the Division of the Federal Register, and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. (See, also, § 23.40, relating to disallowance of loss upon intercompany bad debts.)

[T. D. 5441, 10 F. R. 2425]

§ 23.36 *Limitation on allowable losses on sale of stock, or bonds or other obligations*—(a) *General rule.* No loss shall be allowed under § 23.33, § 23.34, or § 23.35 upon the sale or other disposition of stock or bonds or obligations to the extent that such loss is attributable to (1) transfers of assets within the affiliated group (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period in which the corporations were affiliated (whether or not a consolidated return was made and whether before, during, or after the first taxable year beginning after December 31, 1938), or (2) a distribution during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group.

(b) *Qualification of general rule.* Paragraph (a) of this section shall not be considered as in any way limiting the operation of the provisions of the Code relating to the basis for determining gain or loss upon the sale or other disposition of property (see sections 111 to 115, inclusive), but as being in amplification of and not in substitution for such provisions; subject, however, to this qualification: that to the extent that the transfers of assets referred to in paragraph (a) of this section are taken into account under the terms of the Code in making adjustments in the basis, such transfers will not be taken into account in denying losses under paragraph (a) of this section.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784]

§ 23.37 *Liquidations; recognition of gain or loss*—(a) *During consolidated return period.* (1) Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock, except:

(i) Where such distribution is in complete liquidation and redemption of all of its stock (whether in one distribution or a series) and of its bonds and other indebtedness, if any, falls without the provisions of section 112 (b) (6), and is the result of a bona fide termination of the business and operations of such member of the group, in which case the adjustments specified in §§ 23.34 and 23.35 will be made and § 23.36 will be applicable, or

(ii) Where such a distribution without the provisions of section 112 (b) (6) is one made in cash in an amount in excess of the adjusted basis of the stock, and bonds and other indebtedness, in which case gain shall be recognized to the extent of such excess.

(iii) Where such distribution is in complete liquidation and redemption of all of the stock (whether in one distribution or a series), falls without the provisions of section 112 (b) (6), and is the result of a bona fide termination of the business and operations of such member of the group, in which case it shall be treated as a sale of the stock, the adjustments specified in §§ 23.34 and 23.35 will be made, and § 23.36 will be applicable; and

(iv) Where such a distribution without the provisions of section 112 (b) (6) is one made in cash in an amount in excess of the adjusted basis of the stock.

(2) When the business and operations of the liquidated member of the affiliated group are continued by another member of the group, it shall not be considered a bona fide termination of the business and operations of the liquidated member. (With respect to the acquisition of its bonds by the issuing company, see § 23.41 (b).)

(3) For the purpose of determining whether an affiliated corporation receiving property in a liquidating distribution qualifies under the provisions of section 112 (b) (6) (A), the aggregate amount of the stock of the liquidated corporation owned by the several members of the affiliated group on the date of the adoption of the plan of liquidation and at all times subsequent thereto and prior to

the receipt of the property in liquidation shall be considered as owned by the distributee.

(b) *After consolidated return period.* In case any such distribution is made after a consolidated return period, whether in complete or partial liquidation, except a complete liquidation within the provisions of section 112 (b) (6), with respect to stock and with respect to bonds, debentures, notes, certificates, and other indebtedness of the liquidated corporation acquired prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess-profits tax return was filed, the adjustments specified in §§ 23.34 and 23.35 will be made, and § 23.36 will be applicable.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283]

§ 23.38 *Basis of property*—(a) *General rule.* Subject to the provisions of paragraphs (b) and (c) of this section and except as otherwise provided in §§ 23.34 and 23.39, the basis during a consolidated return period for determining the gain or loss from the sale or other disposition of property, or upon which exhaustion, wear and tear, obsolescence, and depletion are to be allowed, shall be determined and adjusted in the same manner as if the corporations were not affiliated (see sections 111 to 115, inclusive), whether such property was acquired before or during a consolidated return period. Except as otherwise provided in § 23.39, such basis immediately after a consolidated return period (whether the affiliation has been broken or whether the privilege of making a consolidated return is not exercised) shall be the same as immediately prior to the close of such period.

(b) *Intercompany transactions.* The basis prescribed in paragraph (a) of this section shall not be affected by reason of a transfer during a consolidated return period, other than upon liquidation as provided in paragraph (c) of this section (whether by sale, gift, dividend, or otherwise), from a member of the affiliated group to another member of such group.

(c) *Basis after liquidation.* (1) Where property is acquired during a taxable year beginning after December 31, 1938, upon a distribution described in § 23.37 (a) in which gain or loss is recognized to the distributee, the basis of such property shall be its fair market value at date of acquisition.

(2) Where property is acquired during a taxable year beginning after December 31, 1938, upon a distribution in which gain or loss to the distributee is not recognized pursuant to the provisions of section 112 (b) (6), the basis of such property shall be the same as it would be in the hands of the transferor.

(3) Where property is acquired during a taxable year beginning after December 31, 1938, upon a distribution (not a complete liquidation within the provisions of section 112 (b) (6) in which gain or loss to the distributee is not recognized as provided in § 23.37 (a), the basis of such property shall be the same as the basis (determined in accordance with sections 111 to 115, inclusive, and §§ 23.34 and 23.35) of the stock and the bonds and other obligations exchanged therefor, adjusted:

(i) For the transfer of assets within the affiliated group by the distributing corporation (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period for which the corporations were affiliated (whether or not a consolidated return was made and whether before, during, or after the first taxable year beginning after December 31, 1938);

(ii) For distributions during a consolidated return period of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group; and

(iii) For cash received in the distribution.

(4) Where property was acquired either during the month of December 1938 upon a distribution in which gain or loss to the distributee was recognized pursuant to the provisions of section 112 (b) (7) of the Revenue Act of 1938, or during some one calendar month of 1944 upon a distribution in which gain or loss to the distributee was recognized pursuant to the provisions of section 112 (b) (7) of the Code, as added by section 120 (a) of the Revenue Act of 1943, the basis of such property shall be the same as the basis (determined in accordance with sections 111 to 115, inclusive, and § 23.34) of the stock exchanged therefor, adjusted:

(i) For the transfer of assets within the affiliated group by the distributing corporation (by sale, gift, or otherwise)

without consideration or at markedly fictitious values, during the period for which the corporations were affiliated (whether or not a consolidated return was made and regardless of the taxable year in which such transfer occurred);

(ii) For distributions during a consolidated return period of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group;

(iii) For cash received in the distribution; and

(iv) For the amount of gain recognized to the distributee in the liquidation.

(d) *Basis not affected by acquisition or sale of stock.* Neither the acquisition of stock of a corporation nor its sale or other disposition shall affect the basis of the property of such corporation for determining gain or loss or upon which exhaustion, wear and tear, obsolescence, and depletion are to be allowed.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5441, 10 F. R. 2425]

§ 23.39 *Inventories*—(a) *Years beginning prior to January 1, 1941*—(1) *Consolidated return made after separate return.* Where a corporation has made a separate return and in the succeeding taxable year is a member of an affiliated group which makes a consolidated return, the value of its opening inventory to be used in computing the consolidated net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing its net income for the preceding taxable year. For example, Corporation S made a separate return for 1938. It becomes a member of an affiliated group for 1939. Its closing inventory for 1938 was $100,000. The opening inventory for 1939 will be $100,000, assuming that its closing inventory for 1938 was properly computed.

(2) *Separate return made after consolidated return.* If a corporation has been a member of an affiliated group which has made a consolidated return and in the succeeding taxable year makes a separate return, the value of the opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding taxable year. For example, Corporation S joins in making a consolidated return for 1938 and makes a separate return for 1939. The proper value of its closing inventory for 1938 after eliminating intercompany profits is $90,000. Accordingly its opening inventory for computing its net income for 1939 will be $90,000.

(b) *Years beginning after December 31, 1940*—(1) *Consolidated return for first year of affiliation.* If the income of an affiliated corporation is included in a consolidated return for the period immediately following the date upon which such corporation became a member of the affiliated group, the value of its opening inventory to be used in computing the consolidated net income shall be the proper value of the closing inventory used in computing its net income for the preceding taxable year.

(2) *Consolidated return after separate return by affiliates.* If a corporation which is a member of the affiliated group for the first consolidated return period was a member of the group in the preceding taxable year, the value of its opening inventory to be used in computing the consolidated net income for the first consolidated return period shall be the proper value of the closing inventory used in computing its net income for the preceding taxable year decreased in the amount of profits or increased in the amount of losses reflected in such inventory which arose in transactions between members of the affiliated group and which have not been realized by the group through final transactions with persons other than members of the group.

(3) *Separate returns made after consolidated returns.* If a corporation which was a member of an affiliated group in a consolidated return period makes or is required to make a separate return for the succeeding taxable year, the value of its opening inventory to be used in computing its net income for such succeeding taxable year shall be the proper value of its closing inventory used in computing consolidated net income for the last consolidated return period increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group, but in an amount not exceeding, in the case of profits, either the amount of profits arising from such intercompany transactions reflected in the closing inventory of such corpora-

tion for such succeeding taxable year or the amount of such intercompany profits eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this paragraph, and not exceeding, in the case of losses, either the amount of losses arising from intercompany transactions reflected in the closing inventory for such corporation for such succeeding taxable year or the amount of such intercompany losses eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of subparagraph (2) of this paragraph.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283]

§ 23.40 *Bad debts*—(a) *Deduction during consolidated return period.* No deduction shall be allowed during a consolidated return period to any member of the affiliated group on account of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group as of the last day of the taxable year or which was liquidated by the group during such year, except as a loss resulting from a bona fide termination of the business and operations of such other corporation, whether in liquidation or otherwise, in which case the loss will be computed subject to the adjustments specified in § 23.35, and the provisions of § 23.36 shall be applicable.

(b) *Limitation of allowance after consolidated return period.* With respect to obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the group prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments prescribed with respect to the allowance of losses upon the sale of bonds shall be applicable to the allowance of any bad debt deduction for any period subsequent to the consolidated return period. (See § 23.35.)

[T. D. 5244, 8 F. R. 3283]

§ 23.41 *Sale and retirement by corporation of its bonds*—(a) *Issued at discount or premium.* If a corporation which during any taxable year (beginning after December 31, 1938) has been a member of an affiliated group which makes or is required to make a consolidated return, has issued its bonds at a discount or premium (whether before, during, or after the first taxable year beginning after December 31, 1938, and whether or not during a consolidated return period), deduction will be allowed for the amortization of the discount, and income included for the amortization of the premium, in the same manner, to the same extent, and upon the same conditions as if the corporation had never been affiliated, except that no deduction for amortization of discount shall be allowed, and no income shall be included for amortization of premium, during a period for which a consolidated return is made, on bonds of one member of the group owned by another member of the group.

(b) *Acquisition of bonds by issuing company.* If a corporation which during any taxable year (beginning after December 31, 1938) has been a member of an affiliated group which makes or is required to make a consolidated return, acquires its bonds (whether or not from another member of such group and whether or not during a consolidated return period), gain or loss shall be recognized in the same maner, to the same extent, and upon the same conditions as if the corporation had never been affiliated, except that, if such bonds are acquired from another member of the group during a consolidated return period, and in a transaction other than a distribution in a liquidation in which gain or loss to the distributee is recognized pursuant to § 23.37 (a) in determining the gain or loss to the issuing company from such acquisition, the basis thereof to such other member of the group shall be deemed the purchase price.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784]

§ 23.42 *Limitation on capital losses*—(a) *Years beginning prior to January 1, 1941.* The limitations provided by sections 23 (g) and (k), 117 (d) and (e), and 122 (d) upon deductions for losses from sales or exchanges of capital assets shall be applied, in respect of such losses sustained during a consolidated return period beginning prior to January 1, 1941, to each member of the affiliated group in the same manner, to the same extent and upon the same conditions as if a separate return were filed by such member, except that gain or loss will not be recognized upon sales or exchanges be-

tween members of the group. (See, however, § 23.37.)

(b) *Years beginning after December 31, 1940 and prior to January 1, 1942.* The provisions of sections 23 (g) and (k), 117 (d) and (e), and 122 (d) with respect to gains and losses from sales or exchanges of capital assets shall be applied, in respect of such gains and losses sustained during a consolidated return period beginning after December 31, 1940, and prior to January 1, 1942, as if the affiliated group were the taxpayer.

(1) With respect to a net short-term capital loss sustained by a corporation in a year prior to the first consolidated return period in respect of which the income of such corporation is included in the consolidated return, such loss (in an amount not in excess of the net income of such corporation for such year or in excess of the net short-term capital gain of such corporation for the first consolidated return period) shall, for the purposes of section 117 (e), relating to a net short-term capital loss carry-over, be treated as if such net short-term capital loss had been sustained by the affiliated group.

(2) A consolidated net short-term capital loss sustained by the affiliated group during the last consolidated return period of the group (in an amount not in excess of the consolidated net income for such year) shall be treated in the succeeding taxable year, subject to the exception provided in section 117 (e), as a short-term capital loss of the common parent corporation. No portion of any consolidated net short-term capital loss sustained during a consolidated return period of an affiliated group shall be used in computing short-term capital losses of a subsidiary for any subsequent taxable year.

(c) *Years beginning after December 31, 1941.* The provisions of sections 23 (g) and (k), 117 (d), (e), and (j), 122 (d), and 204 (c) (5), with respect to gains and losses from sales or exchanges of capital assets shall be applied, in respect of such gains and losses sustained during a consolidated return period beginning after December 31, 1941, as if the affiliated group were the taxpayer.

(1) With respect to a net short-term capital loss sustained by a corporation in its last taxable year beginning in 1941, a year prior to the first consolidated return period in respect of which the income of such corporation is included in the consolidated return, such loss (in an amount not in excess of the net income of such corporation for such year or in excess of the net short-term capital gain of such corporation for the first consolidated return period) shall, for the purposes of section 117 (e), relating to net short-term capital loss carry-overs, be treated as if such net short-term capital loss had been sustained by the affiliated group.

(2) With respect to a net capital loss sustained by a corporation in a taxable year beginning after December 31, 1941, a year prior to the first consolidated return period in respect of which its income is included in a consolidated return, such loss (in an amount not in excess of the net capital gain of such corporation for succeeding consolidated return periods) shall, for the purposes of section 117 (e), relating to net capital loss carry-overs, be treated as if such net capital loss had been sustained by the affiliated group.

(3) A consolidated net capital loss of an affiliated group for a consolidated return period beginning after December 31, 1941, shall be considered as a consolidated short-term capital loss in subsequent consolidated return periods notwithstanding that one or more corporations, members of the group in the taxable year in which such loss was sustained, make separate returns for subsequent taxable years (or join in a consolidated return made by another affiliated group), but only to the extent that such consolidated net capital loss is not attributable to such corporations; and such portion of such consolidated net capital loss as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year shall be considered as a short-term capital loss in such separate returns, or in such consolidated return of the other affiliated group, but only to the extent that such portion of such consolidated net capital loss was not absorbed in intervening taxable years by net capital gains, consolidated or separate, as the case may be. Any net capital loss sustained by a corporation prior to the first taxable year in respect of which its income is included in the consolidated return, if the consolidated return year begins after December 31, 1941, shall be considered as a short-term capital loss in the sep-

arate return of such corporation (or the consolidated return of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such net capital loss was not absorbed in intervening taxable years by net capital gains, consolidated or separate, as the case may be.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5244, 8 F. R. 3283]

§ 23.43 *Credit for foreign taxes*—(a) *Years beginning prior to January 1, 1941.* The credit allowed a domestic corporation for taxes paid or accrued during a consolidated return period beginning prior to January 1, 1941, to any foreign country or to any possession of the United States (under section 131) shall be computed in the same manner, and upon the same conditions as if a separate return were filed by such corporation, except:

(1) In computing the credit for a taxable year beginning prior to January 1, 1940, the "entire net income" for the taxable year shall be its separate net income as defined in § 23.31 (c), and the "tax against which such credit is taken" shall be that proportion of the tax computed upon the consolidated net income of the affiliated group which is allocable to such corporation,

(2) In computing the credit for a taxable year beginning after December 31, 1939, the "normal-tax net income" for the taxable year shall be its normal-tax net income computed as if a separate return were filed except that the net income used in such computation shall be determined in accordance with the provisions of § 23.31 (c), and the "tax against which such credit is taken" shall be that proportion of the tax computed upon the consolidated normal-tax net income of the affiliated group which is allocable to such corporation, and

(3) The aggregate of the credits for foreign taxes computed for each member of the group shall be credited against the tax computed upon the consolidated net income of the group, or upon the consolidated normal-tax net income of the group, as the case may be.

Example: Corporations P, S_1 and S_2, liable in fact to the tax computed without reduction by reason of any dividends received credit or dividends paid credit, and having no income consisting of interest on obligations of the United States and Government corporations, are affiliated and make a consolidated return for 1939 showing the following results (losses indicated by parentheses):

Company	Domestic income	Foreign income		Total income	Foreign tax	
		British	Canadian		British	Canadian
P	$85,000	$10,000	$5,000	$100,000	$2,000	$500
S_1	(20,000)			(20,000)		
S_2	50,000	(5,000)	5,000	50,000		500
	115,000	5,000	10,000	130,000	2,000	1,000

Consolidated net income $130,000
Income tax 24,700
Allocation of tax:

$$P=\frac{100,000}{150,000}\times\$24,700=\$16,466.67$$

S_1= .... None

$$S_2=\frac{50,000}{150,000}\times\$24,700=\frac{\$8,233.33}{\$24,700.00}$$

Corporation P—

Limitation under section 131 (b) (1):

$$\frac{\text{British income } \$10,000}{\text{Total income } 100,000}\times\$16,466.67=\$1,646.67$$

British tax 2,000.00
Credit limitation $1,646.67

$$\frac{\text{Canadian income } \$5,000}{\text{Total income } 100,000}\times\$16,466.67=\$823.33$$

Canadian tax 500.00
Credit limitation (not in excess of tax paid) 500.00

Total limitation 2,146.67

Corporation P—Continued

Limitation under section 131 (b) (2):

$\frac{\text{Total foreign income } \$15{,}000}{\text{Total income } 100{,}000} \times \$16{,}466.67 = \$2{,}470.00$

Credit allowable	$2,146.67
Corporation S_2—	
Limitation under section 131 (b) (1):	

$\frac{\text{Canadian income } \$5{,}000}{\text{Total income } 50{,}000} \times \$8{,}233.33 = \$823.33$

Canadian tax	500.00	
Credit limitation (not in excess of tax paid)		$500.00
Limitation under section 131 (b) (2):		

$\frac{\text{Total foreign income (none)}}{\text{Total income } \$50{,}000} \times \$8{,}233.33 = 0$

Credit limitation	0	
Credit allowable		None
Aggregate credits for foreign tax:		
Corporation P		$2,146.67
Corporation S_2		None
Total		2,146.67
Income tax payable:		
Income tax		$24,700.00
Credit for foreign income taxes		2,146.67
Balance of income tax		22,553.33

(b) *Years beginning after December 31, 1940.* The credit allowed to an affiliated group for taxes paid or accrued during a consolidated return period beginning after December 31, 1940, to any foreign country or to any possession of the United States (under section 131) shall be computed and allowed as if the affiliated group were the taxpayer.

[Regs. 104, 5 F. R. 7, as amended by T. D. 5127, 7 F. R. 1784, T. D. 5441, 10 F. R. 2425]

§ 23.44 *Methods of accounting*—(a) *In general.* For the purpose of determining consolidated net income, all members of the affiliated group shall adopt that method of accounting which clearly reflects the consolidated net income. A method of accounting which does not treat with reasonable consistency all items of gross income and deductions of the various members of the group shall not be regarded as clearly reflecting the consolidated net income. For example, one member of the group will not be permitted to report items of income or deductions on the cash method of accounting, while another member of the same group reports the same or similar items on the accrual method. The provisions of this paragraph are subject to the exceptions stated in paragraph (b) of this section.

(b) *Combination of methods.* For the purpose of determining consolidated net income, if the members of an affiliated group have established different methods of accounting, each member may retain such method with the consent of the Commissioner, *Provided,* That the consolidated net income is clearly reflected, and, *Provided further,* That intercompany transactions affecting consolidated net income, between members of the group shall be eliminated and adjustments on account of such transactions shall be made with reference to a uniform method of accounting, to be selected by the members of the group with the consent of the Commissioner.

(c) *Change to accrual method.* In the case of a corporation which previously has reported its income (whether in a separate or a consolidated return) in accordance with a method other than the accrual method and is required under this section to report its income for the taxable year under the accrual method, items of income which accrued prior to the taxable year but were properly omitted in the determination of net income under the method of accounting formerly followed shall be included in the income for the taxable year of the change in accounting method, and items of income which were properly included in the determination of net income under the method of accounting formerly followed shall not be included in the income

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for the taxable year of the change or any subsequent year. In such a case, deductions which accrued prior to the taxable year but which were properly omitted in the determination of net income under the method of accounting formerly followed shall be allowed for the taxable year of the change in accounting method, and deductions which were properly included in the determination of net income under the method of accounting formerly followed shall not be allowed in the determination of net income for the taxable year of change or any subsequent year.

[Regs. 104, 5 F. R. 7]

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29.3801 (a) (1)-4 Final disposition of claim for refund as a determination.
29.3801 (a) (3)-1 Related taxpayer.
29.3801 (b)-0 Circumstances of adjustment.
29.3801 (b)-1 Double inclusion of item of gross income.
29.3801 (b)-2 Double allowance of a deduction or credit.
29.3801 (b)-3 Erroneous exclusion of item of gross income with respect to which tax was paid.
29.3801 (b)-4 Correlative deductions and inclusions specified in section 162 (b) and (c) and corresponding provisions of prior revenue acts.
29.3801 (b)-5 Determination of basis of property in case of erroneous treatment of transaction relating to acquisition thereof.
29.3801 (b)-6 Law applicable in determination of error.
29.3801 (b)-7 Operation dependent upon maintenance of inconsistent position.
29.3801 (b)-8 Existence of status of related taxpayer at time of the first maintenance of an inconsistent position.
29.3801 (c)-1 Method of adjustment.
29.3801 (d)-1 Ascertainment of amount of adjustment.
29.3801 (e)-1 Effect of other items on amount of adjustment.
29.3808-1 Deferment of certain taxes of members of the military or naval forces.
29.3808-2 First installment date.
29.3806-3 Tax attributable to service pay.
29.8806-4 Estimated tax for war years.

Subpart H—Miscellaneous Provisions

29.6000 Extensions of time for making certain elections.

SUBPART A—INTRODUCTORY PROVISIONS

AUTHORITY: §§ 29.1-1 to 29-4-1 issued under 53 Stat. 32, 457; 26 U. S. C. 62, 3791.

§ 29.1-1 *Scope and applicability of regulations.* (a) The regulations of this part deal with the taxes upon net income imposed by chapter 1 of the Internal Revenue Code, including the tax imposed by section 102 upon the net income of certain corporations, and with the surtax imposed by subchapter A of chapter 2 (sections 500 to 511) upon the undistributed subchapter A net income of personal holding companies.

(b) The regulations of this part are applicable only with respect to taxable years beginning after December 31, 1941.

[Regs. 111, 8 F. R. 14888]

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

[Regs. 111, 8 F. R. 14889, as amended by T. D. 5391, 9 F. R. 8009]

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

Estates and trusts—sections 161 to 172, inclusive.

Partnerships—sections 181 to 190, inclusive.

Insurance companies—sections 201 to 207, inclusive.

Nonresident alien individuals—sections 211 to 219, inclusive.

Foreign corporations—sections 231 to 237, inclusive.

Income from sources in possessions of the United States—sections 251 and 252.

China Trade Act corporations—sections 261 to 265, inclusive.

Foreign personal holding companies—sections 331 to 340, inclusive.

Regulated investment companies—sections 361 and 362.

Shareholders of personal service corporations—sections 391 to 396, inclusive.

Individuals entitled to elect to pay the tax under Supplement T—sections 400 to 404, inclusive.

[Regs. 111, 8 F. R. 14389, as amended by T. D. 5425, 10 F. R. 10]

SUBPART B—GENERAL PROVISIONS

RATES OF TAX

AUTHORITY: §§ 29.11-1 to 29.58-11 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 29.11-1 to 29.58-11 contained in Regulations 111, 3 F. R. 14832, except as noted following sections affected.

§ 29.11-1 *Income tax on individuals.*—(a) *Taxable years beginning prior to January 1, 1944.* (1) Chapter 1 of the Internal Revenue Code imposes an income tax on individuals, including a normal tax (section 11), a surtax (section 12), and a victory tax (section 450). For optional tax in the case of taxpayers with gross income from certain sources of $3,000 or less, see section 400. The normal tax on individuals is at the rate of 6 percent and is upon net income, which is determined by subtracting the allowable deductions from the gross income. (See generally sections 21 to 24, inclusive.) In certain cases credits are allowed against the net income before computing the tax (section 25) and in other cases against the amount of the tax (sections 31, 32, 35, and 131). In general, the tax is payable upon the basis of returns rendered by persons liable thereto (sections 51, 53, 142, and 217), except that in some instances it is to be paid at the source of the income. Exceptions and additional provisions applicable to certain special classes of taxpayer are listed in section 4.

(2) See Supplement P (sections 331 to 340, inclusive) as to shareholders of foreign personal holding companies. See section 117 as to the treatment of capital gains and capital losses.

(b) *Taxable years beginning after December 31, 1943.* (1) For taxable years beginning after December 31, 1943, chapter 1 imposes an income tax on individuals consisting of a normal tax (section 11) and a surtax (section 12). For optional tax in the case of taxpayers with adjusted gross income of less than $5,000 see section 400 and § 29.400-1 (b). For taxable years beginning after De-

cember 31, 1943, and before January 1, 1946, the normal tax on individuals is at the rate of 3 percent and is upon net income reduced by the amount of the normal tax exemption provided in section 25 (a) for such years and by the credits under section 25 (a) for interest on certain obligations of the United States and obligations of instrumentalities of the United States. For taxable years beginning after December 31, 1945, the normal tax on individuals is determined by computing a tentative normal tax of 3 percent of the amount of the net income in excess of the credits against net income provided in section 25 and by reducing such tentative normal tax by 5 percent thereof.

(2) For treatment of taxable years beginning in 1945 and ending in 1946, see § 29.108-2.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 10, T. D. 5458, 10 F. R. 7335, T. D. 5517, 11 F. R. 6529]

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

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

§ 29.12-1 *Surtax*—(a) *Taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, in addition to the normal tax imposed by section 11 a surtax is imposed at the rates specified in section 12 upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income is the amount of the net income in excess of the personal exemption and credit for dependents. (See generally §§ 29.25-1 to 29.25-7.) For surtax on corporations improperly accumulating surplus, see section 102. As to surtax on personal holding companies, see sections 500 to 511.

(b) *Taxable years beginning after December 31, 1943, and before January 1, 1946.* For taxable years beginning after December 31, 1943, and before January 1, 1946, there is imposed, in addition to the normal tax, a surtax at the rates specified in section 12 prior to its amendment by the Revenue Act of 1945, upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income for such years is the net income minus the credits for surtax exemptions provided in section 25 (b) prior to its amendment by the Revenue Act of 1945.

(c) *Taxable years beginning after December 31, 1945.* (1) For taxable years beginning after December 31, 1945, there is imposed, in addition to the normal tax, a surtax determined as specified in section 12, upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income for such years is the net income minus the credits provided in section 25 (b). Section 12 specifies that the surtax is 5 percent less than the amount of the tentative surtax computed in accordance with the tentative surtax table contained therein.

(2) For treatment of taxable years beginning in 1945 and ending in 1946, see § 29.108-2.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 11, T. D. 5517, 11 F. R. 6530]

§ 29.12-2 *Computation of surtax.* (a) The tables in this section show the surtax (or, for taxable years beginning after December 31, 1945, the tentative surtax) due upon certain specified amounts of surtax net income. In each instance the first figure of the surtax net income in the surtax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the surtax net-income column. The last column gives the total surtax (or total tentative surtax) on a surtax net income equal to the second figure in the surtax net income column.

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

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

SURTAX TABLE

TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1941, AND BEFORE JANUARY 1, 1944

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

SURTAX TABLE

TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1943, AND BEFORE JANUARY 1, 1946

Surtax net income	Percent	Total surtax
$0 to $2,000	20	$400
$2,000 to $4,000	22	840
$4,000 to $6,000	26	1,360
$6,000 to $8,000	30	1,960
$8,000 to $10,000	34	2,640
$10,000 to $12,000	38	3,400
$12,000 to $14,000	43	4,260
$14,000 to $16,000	47	5,200
$16,000 to $18,000	50	6,200
$18,000 to $20,000	53	7,260
$20,000 to $22,000	56	8,380
$22,000 to $26,000	59	10,740
$26,000 to $32,000	62	14,460
$32,000 to $38,000	65	18,360
$38,000 to $44,000	69	22,500
$44,000 to $50,000	72	26,820
$50,000 to $60,000	75	34,320
$60,000 to $70,000	78	42,120
$70,000 to $80,000	81	50,220
$80,000 to $90,000	84	58,620
$90,000 to $100,000	87	67,320
$100,000 to $150,000	89	111,820
$150,000 to $200,000	90	156,820
$200,000 up	91	

TENTATIVE SURTAX TABLE

TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1945

Surtax net income	Percent	Total tentative surtax
$0 to $2,000	17	$340
$2,000 to $4,000	19	720
$4,000 to $6,000	23	1,180
$6,000 to $8,000	27	1,720
$8,000 to $10,000	31	2,340
$10,000 to $12,000	35	3,040
$12,000 to $14,000	40	3,840
$14,000 to $16,000	44	4,720
$16,000 to $18,000	47	5,660
$18,000 to $20,000	50	6,660
$20,000 to $22,000	53	7,720
$22,000 to $26,000	56	9,960
$26,000 to $32,000	59	13,500
$32,000 to $38,000	62	17,220
$38,000 to $44,000	66	21,180
$44,000 to $50,000	69	25,320
$50,000 to $60,000	72	32,520
$60,000 to $70,000	75	40,020
$70,000 to $80,000	78	47,820
$80,000 to $90,000	81	55,920
$90,000 to $100,000	84	64,320
$100,000 to $150,000	86	107,320
$150,000 to $200,000	87	150,820
$200,000 up	88	

(c) The tentative surtax for any amount of surtax net income not stated in round numbers in the tentative surtax table is computed by adding to the tentative surtax for the largest amount stated which is less than the surtax net income, the tentative surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the tentative surtax upon a surtax net income of $63,128 would be $34,866, computed as follows:

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

Since section 12 specifies that the surtax is 5 percent less than the tentative surtax, the surtax upon a surtax net income of $63,128 would be $33,122.70, computed as follows:

Tentative surtax on $63,128	$34,866.00
Less: 5 percent of $34,866	1,743.30
Surtax	33,122.70

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 11, T. D. 5517, 11 F. R. 6530]

§ 29.12-3 *Limitation on amount of tax.* (a) For taxable years beginning after December 31, 1943 and before January 1, 1946 the aggregate amount of the surtax and the normal tax, computed before the application thereto of the credit provided in section 31 (relating to the credit for foreign income tax), section 32 (relating to the credit for tax withheld at the source under section 143 or section 144), and section 35 (relating to the credit for tax withheld on wages), cannot exceed an amount equal to 90 percent of the taxpayer's net income for the taxable year.

(b) For taxable years beginning after December 31, 1945, the aggregate amount of the surtax and the normal tax, computed before the application thereto of the credit provided in section 31 (relating to the credit for foreign income tax), section 32 (relating to the credit for tax withheld at the source under section 143 or section 144), and section 35 (relating to the credit for tax withheld on wages), cannot exceed an amount equal to 85½ percent of the taxpayer's net income for the taxable year. For treatment of taxable years beginning in 1945 and ending in 1946, see § 29.108-2.

[T. D. 5425, 10 F. R. 11, as amended by T. D. 5517, 11 F. R. 6530]

§ 29.13-1 *Tax on corporations in general.* (a) Section 13 imposes an income tax on corporations in general the normal-tax net income of which is more than $25,000. Every such corporation is liable to the tax imposed by such section, except (1) corporations expressly exempt from taxation under chapter 1 (see section 101); (2) corporations subject to tax under section 14, being (1) corporations having normal-tax net incomes of not more than $25,000 and not coming within the provisions of subsection (c), (d), or (e) of such section 14, and (2) foreign corporations engaged in trade or business within the United States; (3) foreign corporations not engaged in trade or business within the United States (see section 231 (a)); (d) insurance companies (see Supplement G (sections 201 to 207)); and (4) regulated investment companies (see Supplement Q (sections 361 and 362)).

(b) It makes no difference that a domestic corporation subject to any tax imposed by section 13 may derive no income from sources within the United States. The tax imposed by section 13 is computed upon the "normal-tax net income," that is, for taxable years beginning before January 1, 1946, the adjusted net income minus the credit provided in section 26 (e) for income subject to the excess profits tax imposed for such years by subchapter E of chapter 2 and minus the credit for dividends received provided in section 26 (b) prior to its amendment by the Revenue Act of 1945. For taxable years beginning after December 31, 1945, the normal-tax net income is the adjusted net income minus the credit for dividends received provided in section 26 (b). Section 26 (b) relates to dividends received from a domestic corporation which is subject to taxation under Chapter 1 (85 percent of dividends received). For taxable years beginning in 1945 and ending in 1946, see § 29.108-2. The "adjusted net income" of a corporation is the net income as defined in section 21 minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities.

(c) The tax imposed by section 13 is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 3797 (a). For surtax on corporations generally, see § 29.15-1. For surtax on personal holding companies, see sections 500 to 511. For surtax on corporations improperly accumulating surplus, see section 102. For treatment of capital gains and losses, see section 117.

(d) The manner of computing the tax imposed by section 13 depends upon the

amount of the corporation's normal-tax net income. If the normal-tax net income is more than $50,000, the tax is 24 percent of the normal-tax net income. If the normal-tax net income is more than $25,000 and not more than $50,000, the tax is $4,250 plus 31 percent of the amount in excess of $25,000.

(e) This section may be illustrated by the following examples:

Example (1). The A Corporation, a domestic corporation, which is not a bank affiliate referred to in section 26 (d), has for the calendar year 1942 a net income of $130,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $10,000 and dividends received (allowable as a credit under section 26 (b)) in the amount of $10,000. It also is entitled to a credit (allowable under section 26 (e)) for income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $20,000. The corporation's tax under section 13 for the calendar year 1942 is $21,960, computed as follows:

Net income	$130,000
Less credit for interest on United States obligations	10,000
Adjusted net income	120,000
Less credit for dividends received (85 percent of $10,000)	$8,500
	111,500
Less credit for income subject to excess profits tax	20,000
Normal-tax net income	91,500
Tax under section 13 (b) (1) (24 percent of $91,500)	21,960

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

[Regs. 111 8 F. R. 14882, as amended by T. D. 5517, 11 F. R. 6530]

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

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

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

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

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

TABLE OF CORPORATION INCOME TAX UNDER SECTION 14 (B)

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

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

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

Example. The A Corporation, a domestic corporation, has for the calendar year 1942 a net income of $28,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $9,000, and dividends received (allowable as a credit under section 26 (b)) in the amount of $5,000. It is also entitled to a credit (allowable under section 26 (e)) for income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $3,050. This tax upon the corporation under section 14 (b) is $1,889, computed as follows:

Net income	$28,000
Less credit for interest on United States obligations	9,000
Adjusted net income	19,000
Less credit for dividends received (85 percent of $5,000)	4,250
	14,750
Less credit for income subject to excess-profits tax	3,050
Normal-tax net income	11,700
Tax on $5,000 at 15 percent	750
Tax on $6,700 at 17 percent	1,139
Total tax	1,889

(h) Section 14 (c) provides for a tax on foreign corporations engaged in trade or business within the United States equal to 24 percent of the normal-tax net income, regardless of the amount thereof. In the case of foreign corporations not engaged in trade or business within the United States, the tax is as provided in section 231 (a). In the case of insurance companies, the tax is as provided in Supplement G (sections 201 to 207). In the case of regulated investment companies, the tax is as provided in Supplement Q (sections 361 and 362).

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

(b) For taxable years beginning before January 1, 1946, the "corporation surtax net income" of a corporation is its net income minus (1) the credit provided in section 26 (e) for income subject to excess profits tax imposed by subchapter E of chapter 2, (2) the credit provided in section 26 (b) for dividends received, and (3) in the case of a public utility, the credit provided in section 26 (h) for dividends paid on its preferred stock. For the purposes of determining the corporation surtax net income, dividends received on the preferred stock of a public utility must be disregarded in computing the credit provided in section 26 (b) for dividends received. For the purposes of determining the corporation surtax net income for taxable years beginning before January 1, 1946, such credit is limited to 85 percent of the corporation's net income reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2, rather than to 85 percent of the adjusted net income so reduced.

(c) For taxable years beginning before January 1, 1946, the rates of corporation surtax are as follows:

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

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

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

(d) For taxable years beginning after December 31, 1945, the "corporation surtax net income" of a corporation is its net income minus (1) the credit provided in section 26 (b) for dividends received and (2) in the case of a public utility, the credit provided in section 26 (h) for dividends paid on its preferred stock. For the purposes of determining the corporation surtax net income, dividends received on the preferred stock of a public utility must be disregarded in computing the credit provided in section 26 (b) for dividends received.

(e) For taxable years beginning after December 31, 1945, the rates of corporation surtax are as follows:

(1) Upon corporation surtax net incomes of $25,000 or less, 6 percent of the amount thereof.

(2) Upon corporation surtax net incomes over $25,000 but not over $50,000, $1,500 plus 22 percent of the amount of such income in excess of $25,000.

(3) Upon corporation surtax net income of more than $50,000, 14 percent of the entire amount thereof.

(f) The credit provided in section 26 (a) for interest received on obligations of the United States or its instrumentalities is not allowable in computing corporation surtax net income for any taxable year.

(g) For treatment of taxable years beginning in 1945 and ending in 1946, see § 29.108-2.

(h) The computation of the surtax on corporations may be illustrated by the following examples:

Example (1). The A Corporation, a domestic corporation which is not a public utility, has for the calendar year 1942 a net income of $86,000. The net income includes dividends received from a corporation which is not a public utility, in the amount of $9,000, and dividends received from the preferred stock of a public utility, in the amount of $3,000. It also includes income subject to the excess profits tax imposed by subchapter E of chapter 2, in the amount of $37,000. The A Corporation's surtax for the calendar year 1942 is $6,097, computed as follows:

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

Example (2). The B Corporation, a domestic corporation which is not a public utility, has for the calendar year 1946 a net income of $75,000. The net income includes dividends received from a corporation which is not a public utility, in the amount of $5,000, and dividends received on the preferred stock of a public utility in the amount of $2,000. The B Corporation's surtax for the calendar year 1946 is $9,905, computed as follows:

Net income	$75,000
Less credit for dividends received (85 percent of $5,000)	4,250
Corporation surtax net income	70,750
Tax (14 percent of $70,750)	9,905

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5517, 11 F. R. 6531]

COMPUTATION OF NET INCOME

§ 29.21-1 *Meaning of net income.* (a) The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered:

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

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

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

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

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

computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. (See section 41.)

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

§ 29.22 (a)-1 *What included in gross income.* (a) Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

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

(c) If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.

NOTE: In the case of property transferred by an employer to an employee pursuant to the exercise of an option granted to the employee before February 26, 1945, the provisions of this section prior to its amendment by Treasury Decision 5507 shall apply.

(d) The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. As to the amount of income tax paid for a bondholder by the obligor pursuant to a so-called tax-free covenant, see section 143 (a) (3). As to the determination of gain or loss from the sale or other disposition of property, see sections 111 to 113, inclusive. As to amounts received as loans from the Commodity Credit Corporation, see section 123. As to income upon a recovery in respect of war losses, see section 127 (c).

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5507, 11 F. R. 4082, T. D. 5600, 13 F. R. 576]

§ 29.22 (a)-2 *Compensation for personal services.* (a) Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, retired pay of Federal and other officers, and pensions or retiring allowances paid by the United States (unless expressly exempt) or by private persons are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist, or religious worker for services rendered. However, so-called pensions awarded by one to whom no services have been ren-

dered are mere gifts or gratuities and are not taxable. The salaries of Federal officers and employees are subject to tax. Amounts deducted and withheld pursuant to the Civil Service Retirement Act of May 29, 1930, 46 Stat. 468, 475, as amended (5 U. S. C., ch. 14), from the basic salary, pay, or compensation of the employees in the civil service of the United States are includible in gross income for the year in which deducted and withheld. As used in this section the term "Federal officers and employees" includes all judges of courts of the United States irrespective of when they took office. Compensation received for services rendered as an officer or employee (including a member of a legislative body and a judge or officer of a court) of a State or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, is to be included in gross income, regardless of the nature of the office or employment.

(b) The value of services need not be included in gross income when rendered directly and gratuitously to an organization described in section 23 (o). Where, however, pursuant to an agreement or understanding services are rendered to a person for the benefit of an organization described in section 23 (o) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services even though at the time of the agreement or understanding the person making the payment acknowledges his liability to make payment to such organization. The second sentence of this paragraph shall not apply where such an agreement or understanding has been entered into prior to May 14, 1942 (the date of the approval of Treasury Decision 5151, 7 F. R. 3708).

§ 29.22 (a)-3 *Compensation paid other than in cash.* If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. If a corporation transfers to its employees its own stock as compensation for services rendered by the employee, the amount of such compensation to be included in the gross income of the employee is the fair market value of the stock at the time of the transfer. If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees. The value of quarters furnished to the commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Army, Navy, Coast Guard, Coast and Geodetic Survey, and Public Health Service, or amounts received by them as commutation of quarters, are to be excluded from gross income. (See also section 22 (b) (6).) Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees. (See § 29.24-3.)

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

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

the cost of goods sold. But see § 29.23 (m)-1 (f).

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

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

(b) In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See § 29.22 (c)-6.)

(c) In every case of the sale of machinery, farm equipment, or other capital assets purchased after February 28, 1913 (which are not to be included in an inventory if one is used to determine profits) any excess over the cost thereof less the amount of depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income, shall be included as gross income. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or the equivalent of money. Proceeds of insurance, such as hail and fire insurance on growing crops, should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see § 29.41-2), be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized.

(d) As used in this subpart the term "farm" embraces the farm in the ordinarily accepted sense, and includes

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

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

§ 29.22 (a)-8 *Sale of stock and rights.* (a) If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock. In the determination of the earliest purchases of stock the rules prescribed in section 117 (h) (relating to the period for which property has been held) shall be applied. The excess of the amount realized on the sale over the cost or other basis of the stock will constitute gain. With respect to the basis for determining gain or loss from the sale or other disposition of stock acquired as a stock dividend or the stock with respect to which the stock dividend was acquired, see §§ 29.113 (a) (19)-1 and 29.113 (a) (19)-2. If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.

(b) Although the issuance by a corporation to its shareholders of rights to subscribe to its stock may not under section 115 (f) give rise to taxible income, gain may be derived or loss sustained by the shareholder from the sale of such rights. In the case of stock in respect of which were acquired stock subscription rights which did not constitute income to the shareholders within the meaning of the sixteenth amendment to the Constitution, and in the case of such rights, subparagraphs (1) to (3) of this paragraph are to be applied:

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

Example. A taxpayer in 1937 purchased 500 shares of common stock at $125 a share, and in 1942, by reason of the ownership of such stock, acquired 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were acquired had a fair market value of $120, and the rights had a fair market value of $3 each. Instead of subscribing to the additional shares, he sold the rights at $4 each. The profit is computed as follows:

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

500 (shares) × $120 = $60,000, market value of old stock

500 (rights) × $3 = $1,500, market value of rights

$\frac{60,000}{61,500}$ of $62,500 = $60,975.61, cost of old stock apportioned to such stock

$\frac{1,500}{61,500}$ of $62,500 = $1,524.39, cost of old stock apportioned to rights

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

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

(2) If the shareholder exercises his rights to subscribe, the basis for determining gain or loss from a subsequent sale of a share of the stock in respect of

which the rights were acquired shall be determined as in paragraph (b) (1) of this section. The basis for determining gain or loss from a subsequent sale of a share of the stock obtained through exercising the rights shall be determined by dividing the part of the cost or other basis, properly adjusted, of the old shares assigned to the rights, plus the subscription price of the new shares, by the number of new shares acquired.

Example. A taxpayer in 1939 purchased 500 shares of common stock at $125 a share, and in 1942, by reason of the ownership of such stock, acquired 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were acquired had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows:

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

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

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

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

(3) If the stock in respect of which the rights are acquired was purchased at different times or at different prices and the identity of the lots cannot be determined, or if the stock in respect of which the rights are acquired was purchased at different times or at different prices and the stock rights acquired in respect of such stock cannot be identified as having been acquired in respect of any particular lot of such stock, the basis for determining the gain or loss from the sale or other disposition of the old shares, or the rights in cases in which the rights are sold, or from the sale or other disposition of the old or new shares in cases in which the rights are exercised, shall be ascertained in accordance with the principles laid down in § 29.113 (a) (12)-1.

(c) As to deductions for losses from sales or exchanges of stocks or bonds, including losses from sales or exchanges of rights to subscribe to stock, see § 29.23 (e)-1.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

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

§ 29.22 (a)-10 *Sale of good will.* Gain or loss from a sale of good will results only when the business, or a part of it, to which the good will attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including good will. (See §§ 29.111-1, 29.113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-2.) If specific payment was not made for good will, there can be no deductible loss with respect thereto, but gain may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or other basis of the good will sold.

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

§ 29.22 (a)-12 *Annuities and insurance policies.* Annuities paid by religious, charitable, and educational corporations under an annuity contract are, in general, subject to tax to the same extent

as annuities from other sources paid under similar contracts. (See section 22 (b) (2) and § 29.22 (b) (2)-2.) An annuity charged upon devised land is taxable to the donee-annuitant to the extent it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land. (See section 22 (b) (3) and § 29.22 (b) (3)-1. As to certain cases in which an annuity charged upon devised land is taxable in full to a spouse upon divorce or legal separation, see section 22 (k). In such case the devisee is not required to return as gross income the amount of rent or other income paid to the annuitant, and he is not entitled to deduct from his gross income any sums paid to the annuitant. Amounts received as a return of premiums paid under life insurance, endowment, or annuity contracts, and the so-called "dividend" of a mutual insurance company which may be credited against the current premium, are not subject to tax.

§ 29.22 (a)-13 *Cancellation of indebtedness*—(a) *In general.* (1) The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who, in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See § 29.22 (a)-(17).) In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

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

(b) *Proceedings under Bankruptcy Act.* (1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under:

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

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

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

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

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

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

§ 29.22 (a)-14 *Creation of sinking fund by corporation.* If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

§ 29.22 (a)-15 *Acquisition or disposition by a corporation of its own capital stock.* (a) Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and

circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

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

§ 29.22 (a)-16 *Contributions to corporation by shareholders.* If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See §§ 29.22 (a)-13 and 29.34-2.

§ 29.22 (a)-17 *Sale and purchase by corporation of its bonds.* (a) (1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (2) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (3) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(b) (1) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (2) If the corporation purchases any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (3) If, however, the corporation purchases any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price, minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income), over the purchase price is gain or income for the taxable year.

(c) (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (2) If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (3) If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

(d) (1) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. (2) If the corporation purchases any of such bonds at a price in excess of the face value of the bonds, the excess of the purchase price over the face value is a deductible expense for the taxable year. (3) If,

however, the corporation purchases any of such bonds at a price less than the face value, the excess of the face value over the purchase price is gain or income for the taxable year.

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

§ 29.22 (a)-18 *Sale of capital assets by corporation.* If property is acquired and later sold for an amount in excess of the cost or other basis, the gain on the sale is income. If, then, a corporation sells its capital assets in whole or in part, it shall include in its gross income for the year in which the sale was made the gain from such sale, computed as provided in sections 111 to 113. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the selling price.

§ 29.22 (a)-19 *Income to lessor corporation from leased property.* If a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the shareholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or shareholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the shareholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns.

§ 29.22 (a)-20 *Gross income of corporation in liquidation.* When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. (See sections 274 and 298.) Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. But see section 44 (d) and § 29.44-5. (See further § 29.52-2.)

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

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

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

(2) The beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (other than certain excepted powers), whether by revocation, alteration or otherwise, exercisable by the grantor, or another person lacking a substantial adverse inter-

est in such disposition, or both (see paragraph (d) of this section); or

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

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

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

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

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

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

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

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

(d) *Power to determine or control beneficial enjoyment of income or corpus.* Income of a trust is taxable to the grantor where, whatever the duration of the trust, the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (except as provided in section 167 (c) and as provided in subparagraphs (1) to (4) of this paragraph), whether by revocation, alteration, or otherwise, exercisable (in any capacity and regardless of whether such exercise is subject to a precedent giving of notice or is limited to some future date) by the grantor, or any person not having a substantial adverse interest in the beneficial enjoyment of the corpus or income, whichever is subject to the power, or both. The grantor is not taxable, however, if the power, whether exercisable with respect to corpus or income, may only affect the beneficial enjoyment of the income for a period commencing 10 years from the date of the transfer (or 15 years where any power of administration specified in

paragraph (c) of this section is exercisable solely by the grantor, or spouse living with the grantor and not having a substantial adverse interest, or both, whether or not as trustee). For example, if a trust created on January 1, 1940 provides for the payment of income to the grantor's wife, and the grantor does not reserve any such administrative power but reserves the power to substitute other beneficiaries in lieu of his wife on or after January 1, 1950, the grantor is not taxable on the trust income for the period prior to January 1, 1950. But the income will be attributable to the grantor for the period beginning on such date unless the power is relinquished. If the beginning of such period is postponed, such postponement is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. But income for any period shall not be taxable to the grantor by reason of the preceding sentence if such income would not be taxable to him in the absence of such postponement. Where the income affected by the power is for a period beginning by reason of some event other than the expiration of a specific term of years, the grantor will be taxable if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be, in accordance with the criteria stated in paragraph (c) of this section.

The foregoing provisions of this paragraph shall not apply to any one or more of the following powers:

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

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

(3) If the power is exercisable by a trustee or trustees, none of whom is the grantor, spouse living with the grantor, or a related or subordinate trustee of the type and under all the conditions referred to in subparagraph (4) (ii) of this paragraph, and the exercise of the power is not subject to the approval or consent of any person other than such trustee or trustees, this subparagraph shall not apply to a power:

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

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

The powers described in this subparagraph include all the powers described in subparagraph (4) of this paragraph, since the latter powers are more limited than those described in this subparagraph.

(4) If the power:

(i) Is exercisable by the grantor or spouse living with the grantor, or both, whether or not as trustee, or

(ii) Is exercisable (*a*) solely by a trustee or trustees who include the father, mother, issue, brother, sister, or employee of the grantor, or a subordinate employee of a corporation in which the grantor is an executive or in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control, and (*b*) in a manner which may affect the interests of beneficiaries which include the spouse or any child of the grantor (see subparagraph (3) of this paragraph for a power exercisable by a related or subordinate trustee of the class hereinabove described where the exercise of the power does not affect the interest of the spouse or a child of the grantor or where the power is exercisable only with the concurrence of an unrelated and nonsubordinate trustee), or

(iii) Is exercisable by any person or persons other than as trustee, or

(iv) Is exercisable by any trustee or trustees, and the exercise of the power is subject to the approval or consent of any person or persons (other than such trustee or trustees), or of the grantor or spouse living with the grantor, or both, in the capacity of trustee,

this paragraph shall not apply:

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

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

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

(*d*) To a power, exercisable only during (*1*) the existence of a legal disability of any current income beneficiary, or (*2*) the period in which any income beneficiary shall be under the age of twenty-one years, to distribute or apply income to or for such beneficiary or to accumulate and add such income to corpus;

(*e*) In a case falling under subdivision (ii) of this subparagraph, to a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions in (*c*) or (*d*) of this subdivision are satisfied: *Provided*, That such power is limited by a reasonably definite external standard. For the requirements of such standard, see (*a*) of this subdivision.

A power does not fall within the powers described in subparagraphs (3) and (4) of this paragraph if the trustee is enabled to add to the class of beneficiaries designated to receive the income or corpus, except insofar as provision may be made for after-born or after-adopted children. A mere power to allocate receipts as between corpus and income, even though expressed in broad language, is not deemed a power over beneficial enjoyment with respect to income or corpus.

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

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

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

grantor and other persons and corporations upon the same terms and conditions; or

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

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

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

(6) The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

(f) *Limitations of section.* (1) Despite the limitations of this section, the grantor of a trust directing the payment or application of the income therefrom in satisfaction of the grantor's legal obligations shall continue to be taxable on the income. The grantor may also be taxable on the income of a trust on the ground that such income is attributable to him in a capacity unrelated to dominion and control over the trust as such as defined in paragraphs (c), (d) and (e) of this section. Thus, the provisions of this section do not affect the principles governing the taxability of future income to the assignor thereof whether or not the assignment is by means of a trust. Nor, for example, do the provisions of this section affect the applicability of section 22 (a) to the creator of a family partnership. See further sections 166 and 167.

(2) Section 22 (a) shall be applied in the determination of the taxability of trust income for taxable years beginning prior to January 1, 1946 without reference to this section.

[T. D. 5488, 11 F. R. 65, as amended by T. D. 5567, 12 F. R. 4395]

NOTE 1: The statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts, issued by the Acting Commissioner, Oct. 10, 1946, 11 F.R. 12044, reads in part as follows:

It will, therefore, be the policy of the Bureau where the grantor's control over a trust created prior to January 1, 1946, is terminated at any time during the calendar year 1946, with the result that the trust income on the last day of such calendar year is no longer taxable to the grantor under the provisions of Treasury Decision 5488, not to assert liability of the grantor under Treasury Decision 5488 for any part of the calendar year 1946. The Bureau may, however, assert liability of the grantor in such a case under section 22 (a) of the Internal Revenue Code without reference to Treasury Decision 5488 for that part of the calendar year 1946 preceding the termination of the grantor's control over the trust.

NOTE 2: Statement, Commissioner of Internal Revenue, approved by the Acting Secretary of the Treasury, June 30, 1947, 12 F.R. 4397 sets forth the following policy regard-

ing extent of application of Treasury Decision 5567, relating to taxability of income of certain trusts:

1. Section 29.22 (a)–21, dealing with the taxation of trust income to the grantor within the principles of Helvering v. Clifford, 309 U. S. 331, was added to Regulations 111 by Treasury Decision 5488, approved December 29, 1945. Section 29.22 (a)–21 was amended by Treasury Decision 5567, approved June 30, 1947. Such section, as amended, is applicable only to taxable years beginning after December 31, 1945. However, it will be the policy of the Bureau, where no inconsistent claims prejudicial to the Government are asserted by trustees or beneficiaries, not to assert liability of the grantor for any prior taxable year under the general provisions of section 22 (a) of the Internal Revenue Code if the trust income would not be taxable to the grantor under the regulations as amended.

2. IT-Mimeograph, Coll. No. 6071, R. A. No. 1544 (11 F.R. 12044), approved October 10, 1946, provided that where the grantor's control over a trust created prior to January 1, 1946 was terminated at any time during the calendar year 1946, with the result that the trust income on the last day of such calendar year was no longer taxable to the grantor under the provisions of § 29.22 (a)–21 of Regulations 111, it would be the policy of the Bureau not to assert liability of the grantor under such provisions for any part of the calendar year 1946. In view of the amendments made by Treasury Decision 5567 grantors who have not heretofore terminated their substantial ownership of the trust income under IT–Mimeograph 6071 may now desire to terminate such controls over the trusts as subject them to tax under the provisions of § 29.22 (a)–21 as amended by Treasury Decision 5567.

It will, therefore, be the policy of the Bureau where the grantor's control over a trust created prior to January 1, 1946 is terminated at any time prior to January 1, 1948 with the result that the trust income on the last day of the calendar year 1947 is no longer taxable to the grantor under the provisions of § 29.22 (a)–21 as amended by Treasury Decision 5567 not to assert liability of the grantor under these regulations for any part of the calendar years 1946 and 1947. The Bureau may, however, assert liability of the grantor in such a case under section 22 (a) of the Internal Revenue Code without reference to § 29.22 (a)–21 for any part of the calendar year 1946 or the calendar year 1947 preceding the termination of the grantor's control over the trust. The complete repayment by the grantor prior to January 1, 1948 of a loan of trust corpus or income made to him directly or indirectly prior to January 1, 1946, shall be considered, for the purposes of the applicability of this mimeograph, a termination (with respect to such loan) of the controls defined in paragraph (e) (3) of § 29.22 (a)–21, as amended.

Correspondence in regard to this mimeograph should refer to Coll. No. 6156, R. A. No. 1595, and the symbols IT:EIM.

§ 29.22 (a)–22 *Trust income taxable to person other than grantor.* (a) Where a person other than the grantor of property transferred in trust has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, the income therefrom shall be included in computing the net income of such person. Even though such a power has been partially released or otherwise modified so that the person holding it can no longer vest the corpus or the income of the trust in himself, the income shall continue to be taxable to such person if, after such release or modification, he has retained such control of the trust as would, within the principles of § 29.22 (a)–21, subject a grantor of such a trust to tax on the income thereof. This section shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor is otherwise taxable under § 29.22 (a)–21. See also § 29.166–2.

(b) Section 22 (a) shall be applied in the determination of the taxability of trust income for taxable years beginning prior to January 1, 1946 without reference to this section.

[T. D. 5488, 11 F. R. 65]

CROSS REFERENCE: For statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts, see note to § 29.22 (a)–21.

§ 29.22 (b)–1 *Exemptions; exclusions from gross income.* Certain items of income specified in section 22 (b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items are exempt from gross income except (a) those items of income which are, under the Constitution, not taxable by the Federal Government; (b) those items of income which are exempt from tax on income under the provisions of any act of Congress still in effect; and (c) the income exempted under the provisions of section 116. Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the Internal Revenue Code to be made from gross income in computing net income. As to other items not to be included in gross income, see sections 22 (k), 112, 119, 127 (c), and

171 and Supplements G, H, I, and J (sections 201 to 252). Section 607 (f) of the Merchant Marine Act of 1936, as amended by section 28 of the act of June 23, 1938 (52 Stat. 961), and changed to section 607 (h), reads as follows:

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

§ 29.22 (b) (1)-1 *Life insurance; amounts paid by reason of the death of the insured.* The proceeds of life insurance policies, paid by reason of the death of an insured to his estate or to a beneficiary (individual partnership, or corporation), directly or in trust, are excluded from the gross income of the beneficiary, except in the case of certain transferees as provided in § 29.22 (b) (2)-3 and in the case of a spouse to whom such payments are income under section 22 (k). It is immaterial whether the proceeds are received in a single sum or otherwise. If, however, such proceeds are held by the insurer under an agreement to pay interest thereon, the interest payments must be included in gross income.

[T. D. 5515, 11 F. R. 5474]

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

§ 29.22 (b) (2)-2 *Annuities.* (a) Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semiannually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. Such portion of each installment payment of an annuity (where the whole payment is not required to be included in income under section 22 (k)) shall be included in gross income as is not in excess of 3 percent of the aggregate premiums or consideration paid for such annuity, whether or not paid during the taxable year, divided by 12 and multiplied by the number of months in respect of which the installment is paid. As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. Annuities paid to retired employees pursuant to the Civil Service Retirement Act of May 29, 1930, 46 Stat. 468, 475, as amended (5 U. S. C., 1940 ed., ch. 14), are subject to section 22 (b) (2), the aggregate premiums or consideration paid for such annuities being the total of the amounts previously withheld from the compensation of the employees.

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

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

Example (2). A bought an annuity on October 1, 1942, paying $100,000 as consideration therefor. The annuity amounts to $7,824 a year, payable in semiannual installments of $3,912, and on December 1, 1942, A received $1,304, the first payment under the contract being for a 2-month period. A shall include in his gross income for the calendar year 1942 the sum of $500, being 3 percent of $100,000 (the consideration paid) divided by 12 and multiplied by 2 (the number of months in respect of which the installment was paid).

Example (3). A bought an increasing annuity on August 1, 1942, paying $40,000 as consideration therefor. The annuity amounts to $1,000 a year for the first year, $2,000 a year for the second year, and $3,000 a year

thereafter, payable in quarterly installments. A received the first quarterly installment on November 1, 1942, amounting to $250. A shall include in his gross income for the calendar year 1942 the sum of $250, being such portion of the installment as is not in excess of 3 percent of $40,000 (the consideration paid) divided by 12 and multiplied by 3 (the number of months in respect of which the installment was paid).

§ 29.22 (b) (2)-3 *Transfers of life insurance, endowment, or annuity contracts.* (a) In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, to which section 22 (b) (1) or (2) (A) applies, only the actual value of the consideration given for such transfer and the amount of the premiums and other sums subsequently paid by the transferee shall be excluded from gross income, in lieu of the amounts provided in § 29.22 (b) (1)-1, § 29.22 (b) (2)-1, or § 29.22 (b) (2)-2, to be excluded with respect to payments under such life insurance, endowment, or annuity contract. In the event of such a transfer (other than to the insured), the rule stated in the preceding sentence transforms the exemption applicable under section 22 (b) (1) or (2) (A) from that determined as in the case of the insured or person to whom the policy was originally issued to an exemption determined as in the case of a transferee for a valuable consideration. The exemption applicable in the case of a transferee without valuable consideration or a donee beneficiary is determined in accordance with the rule applicable in the case of its last transferor or last owner of the policy. For the purpose of determining gross income in the case of a transfer of a life insurance, endowment, or annuity contract or any interest therein, if such contract or interest therein has a basis for determining gain or loss in the hands of the transferee determined, in whole or in part, by reference to such basis of such contract or interest therein in the hands of the transferor, the rule stated in the first sentence of this section shall not apply as to such transfer, and the rule applicable under section 22 (b) (1) or (2) (A) to a transferee without valuable consideration (as stated in the preceding sentence) shall apply as if the transfer from such transferor to such transferee were without valuable consideration. Thus, where a corporation acquires a life insurance policy from a predecessor corporation in a tax-free reorganization, if the proceeds received under the policy by reason of the death of the insured would be exempt from taxation in the hands of the transferor, such proceeds received by reason of the death of the insured will be exempt from taxation in the hands of the transferee, because the basis is determined with reference to the basis in the hands of the transferor.

(b) The following examples illustrate the application of the provisions of this section:

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

Example (2). In 1922, Y took out an annual premium 20-year endowment policy having a maturity value of $20,000. After payment of premiums totaling $5,500, Y assigned the policy to the M Corporation for a consideration of $4,000. If the M Corporation held the policy and paid the premiums thereon, the $20,000 received upon maturity of the policy (while A is still alive) would be includible in the income of the M Corporation, except to the extent of the $4,000 consideration paid by it and the premiums which it paid after the transfer. If, prior to the maturity of the policy, the M Corporation transferred its assets, including the policy, to the N Corporation in a tax-free exchange for the stock of the N Corporation and the N Corporation held the policy until maturity (1942), paying all premiums due thereon after such transfer, the $20,000 received by the N Corporation would be includible in its gross income, except to the extent of the $4,000 consideration paid by the M Corporation for the transfer of the policy from Y and the aggregate premiums paid by the M and N Corporations upon the policy.

§ 29.22 (b) (2)-4 *Annuity, etc., payments in discharge of alimony obligation.* The full amount of any periodic payment received under a life insurance, endowment, or annuity contract by a spouse

or former spouse is required to be included in her gross income if certain conditions specified in section 22 (k) exist. See § 29.22 (k)-1. Paragraphs 1 and 2 (A) of section 22 (b) do not apply (except the last sentence of section 22 (b) (2) (A)) with respect to so much of a payment as under section 22 (k) is includible in gross income. For example, upon the divorce of a husband and wife, the decree may require the husband to provide the wife with an annuity of $2,000 for her life. The wife, being desirous of a greater assured income, may pay with the husband to an insurance company a consideration which, when added to the amount paid by the husband, purchases an annuity paying $3,000. For each taxable year, $2,000 is to be included in her income under section 22 (k) and such portion of $1,000 is to be included in her income as is required under § 29.22 (b) (2)-2 on the basis of the consideration paid by her to the company.

§ 29.22 (b) (2)-5 *Employees' annuities.* (a) If an employer purchases an annuity contract on behalf of an employee, including a retired or former employee, under a plan with respect to which his contribution is deductible under section 23 (p) (1) (B) (see § 29.23 (p)-9), the employee is not required to include such amount in his income in the taxable year during which such contribution is made. The amount received or made available to such employee under such annuity contract shall be included in gross income of the employee in the taxable year in which received or made available, except that if the employee contributed any of the consideration for the annuity, the annuity shall be included in his income as provided in § 29.22 (b) (2)-2, the consideration for the annuity being considered the amount contributed by the employee. If an employer purchases an annuity contract which is not under a plan with respect to which his contribution is deductible under section 23 (p) (1) (B), the amount of such contribution shall be included in the income of the employee in the taxable year during which such contribution is made, if the employee's rights under the annuity contracts are nonforfeitable, except for failure to pay future premiums, at the time the contribution is made. In such case, the total amount of such contributions required to be included in the income of the employee together with any amounts contributed by him will constitute the consideration paid for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 22 (b)-(2) (A). If the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee, but any amount received or made available to the employee under the annuity contract shall be includible in the gross income of the employee in the taxable year in which received or made available, except that if the employee contributed any of the consideration for the annuity, the annuity shall be included in his income to the extent provided in § 29.22 (b) (2)-2. The fact that an employee may not live a sufficient length of time to enjoy any benefits under the annuity contract, or that no payments will be made under any circumstances to his estate or other beneficiary, will not make the annuity contract forfeitable.

(b) If upon the death of a retired employee, the widow or other beneficiary of such retired employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the amounts received or made available to her shall be included in her income to the extent that they would have been included in the income of the deceased employee had he lived and received such payments. See also section 126 (a). As to taxation of life insurance benefits in connection with annuity contracts, see § 29.165-6.

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

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

(e) As to the effective date of the amendments made by section 162 (c) of the Revenue Act of 1942, relating to em-

ployees' annuities and the effect of such amendments on both old and new annuity plans, see section 162 (d) of the Revenue Act of 1942 (set forth immediately preceding §§ 29.23 (p)-1) and 29.165-5.

§ 29.22 (b) (3)-1 *Gifts and bequests.* (a) Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. If the gift, bequest, devise, or inheritance is of income from property, it is not to be excluded from gross income. An amount of principal paid under a marriage settlement is a gift. As to alimony or an allowance paid upon divorce or legal separation, see § 29.22 (k)-1.

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

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

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

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

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

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

gated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.

§ 29.22 (b) (4)-2 *Dividends from shares and stock of Federal agencies or instrumentalities*—(a) *Issued prior to March 28, 1942.* (1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U. S. C. 931), provides that Federal land banks and national farm-loan associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (38 Stat. 258, 12 U. S. C. 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 5 (h) of the Home Owners' Loan Act of 1933 (48 Stat. 133, 12 U. S. C. 1464 (h)), provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, national farm-loan associations, and Federal reserve banks is not, in the case of stock issued prior to March 28, 1942, subject to the income tax; and income consisting of dividends on share accounts of Federal savings and loan associations is not, in the case of shares issued prior to March 28, 1942, subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

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

(3) Dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933, constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (48 Stat. 267, 12 U. S. C. 1138c)).

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

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. This paragraph may be illustrated by the following examples:

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

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued prior to March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to

have been issued prior to March 28, 1942. On December 31, 1943, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 27, 1942.

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

§ 29.22 (b) (4)-3 *Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.* Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U. S. C., 931), and section 210 of such act, as added by section 2 of the act of March 4, 1923 (42 Stat. 1450, 12 U. S. C., 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

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

(2) Every person owning any of the obligations enumerated in clause (A), (B), or (C) of section 22 (b) (4) shall submit in his income tax return for any taxable year beginning before January 1, 1944, a statement showing the number and amount of such obligations owned and the income received therefrom. For the purpose of such statement, in the case of Treasury bills issued after June 17, 1930, (i) the "amount of such obligations" is their par (maturity) value and (ii) the "income received therefrom" is the net excess of the amount realized during the taxable year from the sale or other disposition of the bills over the cost or other basis thereof, a separate computation of discount being unnecessary.

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

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

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

(6) Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U. S. C., 931), and section 210 of such act, as added by section 2 of the Act of March 4, 1923 (42 Stat. 1459, 12 U. S. C., 1111), provided that farm-loan bonds issued by Federal land banks and joint-stock land banks and debentures issued by Federal intermediate credit banks, with the income therefrom, shall be exempt from taxation. Accordingly, interest from such farm-loan bonds or debentures is not subject to the income tax.

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

(b) *Issued on or after March 1, 1941.* (1) By virtue of the provisions of sec-

tions 4 and 5 of the Public Debt Act of 1941 (55 Stat. 9), the exemption prescribed in paragraph (a) of this section is limited to such bonds, debentures, notes, or certificates of indebtedness as have been issued prior to March 1, 1941. Under such provisions of the Public Debt Act of 1941, interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal tax now or hereafter imposed except in respect of any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes of this section, under section 4 (a) of the Public Debt Act of 1941, a Territory, a possession of the United States, and the District of Columbia and any political subdivisions thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

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

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

§ 29.22 (b) (4)-6 *Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.* By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (40 Stat. 1311), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (40 Stat. 845), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued prior to March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in § 29.22 (b) (4)-4 (b).

§ 29.22 (b) (9)-1 *Income from discharge of indebtedness.* (1) Section 22 (b) (9) provides, with respect to taxable years beginning after December 31, 1941, and before January 1, 1950, a method whereby a corporation may elect to have excluded from its gross income the amount of income attributable to a discharge, within the taxable year, of its indebtedness or of indebtedness for which it is liable as, for example, in the case of a debt arising from an assumption of liability of another corporation. To be entitled to the benefits of the provisions of section 22 (b) (9) for such years a corporation must file with its return for the taxable year a consent to the provisions of the regulations, in effect at the time of the filing of the return, prescribed under section 113 (b) (3) (see §§ 29.113 (b) (3)-1 and 29.113 (b) (3)-2, relating to adjustment of basis).

(2) As used in this section "indebtedness" means indebtedness evidenced by a security, that is, by a bond, debenture, note, or certificate, or other evidence of indebtedness issued by either the tax-

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payer corporation or any other corporation regardless of when issued.

(3) Discharges of indebtedness (including discharges occurring in a proceeding under Chapter XV of the Bankruptcy Act of 1898, as amended, if such proceeding was initiated by petition filed on or after October 16, 1942, and on or before November 1, 1945) occurring in a taxable year beginning after December 31, 1941, and prior to January 1, 1950, are governed by the provisions of section 22 (b) (9).

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5576, 12 F. R. 6071]

§ 29.22 (b) (9)-2 *Making and filing of consent.* A consent to have the basis of its property adjusted in accordance with the provisions of the regulations, in effect at the time of filing of the return, prescribed under section 113 (b) (3) (see §§ 29.113 (b) (3)-1 and 29.113 (b) (3)-2) shall be made by or on behalf of the taxpayer corporation in duplicate on Form 982, in accordance with this part and the instructions on the form or issued therewith. The original and duplicate shall be filed with the return.

§ 29.22 (b) (10)-1 *Income from discharge of indebtedness of railroad corporations.* (a) Under section 22 (b) (10) the amount of any income attributable to the discharge within the taxable year, of any indebtedness of a railroad corporation as a result of an order of a court in a receivership proceeding, or in a railroad reorganization proceeding under section 77 of the Bankruptcy Act of 1898, as amended, is, for taxable years beginning before January 1, 1950, excluded from the gross income of the railroad corporation. The section is applicable only in a case where income accrues to a taxpayer from the modification or cancellation of the corporate indebtedness (whether in whole or in part) pursuant to a court order.

(b) The railroad corporation to which this section and section 22 (b) (10) apply are those defined in section 77m of the Bankruptcy Act of 1898, as amended, namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

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

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

(e) The provisions of section 22 (b) (10) and this section are applicable to taxable years beginning before January 1, 1950.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5576, 12 F. R. 6071]

§ 29.22 (b) (11)-1 *Exclusion from gross income of lessor of real property of value of improvements erected by lessee.* (a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property

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

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

Example. The A Corporation leased in 1935 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1937. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1942, when the improvements had a value of $100,000. Under the provisions of section 22 (b) (11), the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. If, in this example, the lease covered a period of only 25 years and the building upon completion had an estimated value of $75,000 as of the end of the lease term and in accordance with an option granted by the regulations the A Corporation included in gross income the sum of $3,000 for each taxable year from 1937 to 1941, both years inclusive, then there shall be excluded from gross income for the taxable year 1942 and subsequent taxable years any such amounts otherwise includible in gross income for such years and attributable to the building erected by the B Corporation, notwithstanding the exercise of such option. As to the basis of the property in the hands of the A Corporation, see § 29.113 (c)-1.

§ 29.22 (b) (12)-1 *Recovery of certain items previously deducted*—(a) *In general.* Section 22 (b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. See *Dobson* v. *Commissioner*, 64 S. Ct. 239. The term "recovery exclusion" as used in this subpart means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amount (the items specifically referred to in section 22 (b) (12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

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

against the party from whom such stock had been purchased.

(2) *Definition of "recovery."* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 22 (b) (12) items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 22 (b) (12), that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 22 (b) (12) item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery." Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 22 (b) (12) item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 22 (b) (12) item. Such gain is in no case excluded from gross income under section 22 (b) (12), regardless of whether the $40 recovery is or is not excluded.

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

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.* For taxable years beginning after December 31, 1937, bad debts on account of certain worthless securities and, for taxable years beginning after December 31, 1942, certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See section 23 (k) of the Internal Revenue Code, and section 23 (k) of the Revenue Act of 1938. The amount of the deductions allowed for any year under section 117 (d) on account of such losses for such year is considered to be section 22 (b) (12) items. Any part of such losses which, under section 117 (d), is a deduction for a subsequent year through the capital loss carry-over (any later receipt of an amount with respect to such deducted loss is a recovery) is considered a section 22 (b) (12) item for the year in which such loss was sustained.

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

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.* The recovery exclusion for the taxable year for which section (b) (12) items were deducted or section 22 (b) (12) items were deducted or credited (that is, the "original taxable amount of such deductions and credits which could be disallowed without caus-

ing an increase in any tax of the taxpayer imposed under chapter 1 of the Internal Revenue Code (such as the normal tax, surtax, and victory tax), other than the tax imposed on corporations by section 102 for the improper accumulation of surplus, or in any tax imposed under corresponding provisions of prior revenue laws. For this purpose, consideration must be given to the effect of net operating loss carry-overs and carry-backs or capital loss carry-overs.

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

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

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

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

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

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

The $1,600 aggregate of the section 22 (b) (12) items is reduced by the $300 difference between the surtax net income for 1942 computed with and without regard to such aggregate, since this difference is greater than such difference between the incomes subject to normal tax, ascertained as follows:

	With deduction of section 22 (b) (12) items	Without deduction of section 22 (b) (12) items
Gross income	$2,800	$2,800
Less: Depreciation	2,000	2,000
Remainder	800	800
Less: Bad debts and taxes	1,600	
Net income or (loss)	(800)	800
Personal exemption	500	500
Surtax net income	0	300
Earned income credit	0	80
Net income subject to normal tax	0	220
Difference between surtax net incomes ($300-$0)		300
Difference between incomes subject to normal tax ($220-$0)		220

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

In 1946 the taxpayer recovers $400 of the property taxes. All of this recovery is excluded from income by reason of the recovery exclusion of $500 determined for the original year 1942. In 1947 he recovers all of the bad debt of $900, of which $100 is excluded from gross income. That is, the recovery exclusion of $500 determined for the original year 1942 is reduced by the $400 recovery in 1946 on account of the section 22 (b) (12) items deducted for such original year.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5307, 8 F. R. 16187, T. D. 5454, 10 F. R. 5500]

§ 29.22 (b) (13)-1 *Compensation of members of military and naval forces.* (a) In addition to the exemptions and credits otherwise applicable, section 22 (b) (13) provides that there shall be excluded from gross income:

(1) In the case of compensation received for active service as a member below the grade of commissioned officer (or commissioned warrant officer) in the military or naval forces of the United States, the entire amount of such compensation.

(2) In the case of compensation received in a taxable year beginning after December 31, 1942, for active service (i) as a commissioned officer (or commissioned warrant officer) in the military or naval forces of the United States, or (ii) as a member of the military or naval forces of any of the other United Nations, if such member is a citizen or resident of the United States, so much of such compensation as does not exceed $1,500.

(b) The exclusions under section 22 (b) (13) and this section are applicable only to compensation received prior to January 1, 1949. Such exclusions are applicable without regard to the marital status of the recipient of the compensation, and if a husband and wife both meet the requirements of the statute, then each is entitled to the benefit of an exclusion. For the purposes of this section the military and naval forces of the United States include (but are not necessarily limited to) the Army, the Navy, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Navy Nurse Corps, Female, the Women's Army Auxiliary Corps or the Women's Army Corps, the Women's Reserve branch of the Naval Reserve, the Marine Corps Women's Reserve, and the Coast Guard Reserve, including the Coast Guard Women's Reserve. Personnel serving with the Army Specialist Corps are not within the scope of the exemption. For the purposes of this section the term "member of the military or naval forces of any of the other United Nations" shall mean any individual whose duties in the service of any of the United Nations other than the United States correspond to those of any member of the military or naval forces of the United States as defined in this section.

(c) A person is in active service if he is actually serving in such forces, not necessarily in the field or in the theater of war. Personnel in the inactive reserve or on retirement are not in active

service. Periods during which a person is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service.

(d) In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion from gross income under section 22 (b) (13) operates before apportionment of the gross income of the spouses in accordance with community property laws. For example, a man and his wife are domiciled in such a State and he is entitled to the benefit of the exclusion under section 22 (b) (13) as a commissioned officer of the armed forces. He receives during 1943 compensation for active service in such forces in the amount of $2,000. Of such amount only $500 is taken into account in determining the gross income of both husband and wife.

[T. D. 5508, 11 F. R. 4230, as amended by T. D. 5645, 13 F. R. 4256]

§ 29.22 (b) (14)-1 *Mustering-out payments of military and naval forces.* The exclusion from gross income under section 22 (b) (14) of mustering-out payments with respect to service in the military and naval forces applies only with respect to taxable years beginning after December 31, 1943. For the purposes of such exclusion mustering-out payments are payments made to any recipients pursuant to the provisions of the Mustering-Out Payment Act of 1944.

[T. D. 5371, 9 F. R. 5111]

§ 29.22 (c)-1 *Need of inventories.* In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 29.22 (d)-1.)

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

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

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the eventory 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 inventory or basis of valuation so long as the method or basis used is substantially in accord with the regulations in this part. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 29.22 (c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (1) or (2) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability

and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

(d) In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22 (d) or to animals inventoried under the elective "unit-livestock-price method" authorized by § 29.22 (c)-6. Taxpayers were given an option to adopt the basis of either (1) cost or (2) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in § 29.41-2. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22 (d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

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

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part, viz:

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

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

(3) Omitting portions of the stock on hand.

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

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

[Regs. III, 8 F. R. 14882, as amended by T. D. 5423, 9 F. R. 14712]

§ 29.22 (c)-3 *Inventories at cost.* Cost means:

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

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

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including

any cost of selling or return on capital, whether by way of interest or profit.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (1) farmers and raisers of live stock (see § 29.22 (c)-6), (2) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 29.22 (c)-7), and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 29.22 (c)-8).

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

(1) Of goods purchased and on hand, and

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

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

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

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

(a) At cost,

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

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in § 29.41-2. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purpose of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such

buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.

§ 29.22 (c)-6 *Inventories of livestock raisers and other farmers.* Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in paragraphs (a) and (b) of this section. 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 for the year for which the option is exercised and for subsequent years unless another method be authorized by the Commissioner.

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

(b) No adjustment sheets will be required, but the net income for the taxable year in which the change is made must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory of livestock, crops, and products at the beginning of the year: *Provided, however:*

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

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

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

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method." If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in § 29.41-2.

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

subject to approval by the Commissioner upon examination of the taxpayer's return.

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

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

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in § 29.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock for taxable years beginning after December 31, 1943 without formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method."

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5423, 9 F. R. 14712]

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

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

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

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to subparagraph (1) of this paragraph. For further adjustments to be made in the case of a retail merchant using the elective inventory method authorized by section 22 (d), see § 29.22 (d)-1.

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

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

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

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

(f) A taxpayer (other than one using the elective inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices, may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by § 29.41-2. A taxpayer filing a first return of income may adopt such practice subject to approval by the Commissioner upon examination of the return.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5605, 13 F. R. 1281]

§ 29.22 (d)-1 *Inventories under elective method.* (a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22 (c), and pursuant to the provisions of §§ 29.22 (c)-1 to 29.22 (c)-8, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22 (d). Under this elective inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

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

(2) Second, those acquired during the taxable year.

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

(b) If the elective inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (i. e., those not legally subject to cancellation by either party) entered into at fixed prices on or before

the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and that, in the opinion of the Commissioner, income is clearly reflected thereby.

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

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

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
	Cents	*Cents*	*Cents*
Raw material	60	60	60
Processing cost		10	20
Overhead		05	10

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

CLOSING INVENTORY

[Based on cost and prior to adjustment]

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

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

CLOSING INVENTORY AS ADJUSTED

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

[1] This excess is subject to determination of price under section 22 (d) (1) (B) and § 29.22 (d)-2 of this part. If the excess falls in goods in process the same adjustment is applicable.

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

Example (2). Assume the opening inventory had 5 units of raw material, 10 units of goods in process and 20 units of finished goods with the same prices as in Example (1) and the closing inventory had 20 units of raw material, 20 units of goods in process and 10 units of finished goods, with raw material costs as in the closing inventory in example (1).

The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material	Goods in process	Finished goods
20 @ 6¢=$1.20	15 @ 6¢=$0.90 5 @ 10¢=$0.50 [1]	None @ 6¢=$0.00. 10 = 10¢=$1.00.[1]

[1] This excess is subject to determination of price under section 22 (d) (1) (B) and § 29.22 (d)-2 of this part.

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

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

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

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

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

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

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

(j) This election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product, for example, in the case of cotton and rayon yarn the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the elective inventory method may not now elect to exclude any raw materials that were covered by such previous election. If a taxpayer using the retail method of pricing inventories, authorized by § 29.22 (c)-8, elects to use in connection therewith the elective inventory method authorized by section 22 (d) of the Code, the apparent cost of the goods on hand at the end of the year, determined pursuant to § 29.22 (c)-8, shall be adjusted to the extent of price changes therein taking place subsequent to the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indices established to the satisfaction of the Commissioner. Price indices prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indices which are based upon inadequate records, or which are not subject to complete and detailed audit within the Bureau, will not be approved.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5407, 9 F. R. 12336, T. D. 5605, 13 F. R. 1281]

§ 29.22 (d)-2 *Requirements incident to adoption and use of elective method.* Except as otherwise provided in § 29.22 (d)-1 with respect to raw material computations and with respect to retail inventory computations, the adoption and use of the elective inventory method is, by section 22 (d) and regulations thereunder, made subject to the following requirements:

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

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

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

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be

included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of Rule (A) or Rule (B) of this section, dependent upon the character of the transactions in which the taxpayer is engaged;

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

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

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

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

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

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

The application of Rule (A) may be illustrated by the following examples:

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

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

and that it has a 1942 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(*a*) Most recent purchases—

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

or

(*b*) In order of acquisition—

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

or

(*c*) At an annual average—

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

Example (2). Suppose that the taxpayer's closing inventory for 1943, the year following that involved in example (1), reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1943 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken "in the order of acquisition" pursuant to section 22 (d) (1) (B), and inasmuch as the character of the taxpayer's opening inventory for the year will be dependent upon its method of valuing its five-unit inventory increase for the preceding year, the closing inventory for 1943 will be computed as follows:

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

10 at 10 (from 1941)	=100
1 at 13 (July 1942)	= 13
2 at 14 (October 1942)	= 28
Total 13	141

or

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

10 at 10 (from 1941)	=100
1 at 11 (January 1942)	= 11
2 at 12 (April 1942)	= 24
Total 13	135

or

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

10 at 10 (from 1941)	=100
3 at 13 (from 1942)	= 39
Total 13	139

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

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

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

(e) The taxpayer shall establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining income, profit, or loss for the taxable year for which the elective inventory method is first used or for any subsequent taxable year, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in § 29.22 (d)-1 or at variance with the requirement referred to in paragraph (c) of this section, the taxpayer's use of market value in lieu of cost or his issuance of reports or credit statements covering a period of operations less than the whole of the taxable year not being considered at variance with this requirement;

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

(g) The elective inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless:

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

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the elective inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in § 29.22 (d)-1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter; and

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 29.22 (d)-1; and such supplemental and detailed inventory records shall be maintained as will enable the Commissioner readily to verify the taxpayer's inventory computations as well as his compliance with these several requirements.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5504, 11 F. R. 3080, T. D. 5605, 13 F. R. 1281]

§ 29.22 (d)-3 *Time and manner of making election.* (a) The elective inventory method may be adopted and used only if the taxpayer files with his return for the taxable year as of the close of which the method is first to be used (or, if such return is filed prior to March 10, 1943, the ninetieth day after the approval of Treasury Decision 5199, 7 F. R. 10366, then at any time prior to such date) in triplicate on Form 970, and pursuant to the instructions printed thereon and to the requirements of this section, a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the elective method is proposed first to be used, and also as of the beginning of the preceding taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

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

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

payer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

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

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

§ 29.22 (d)-5 *Revocation of election.* An election made to adopt and use the elective inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method be required by the Commissioner, or authorized by him pursuant to a written application therefor filed with him as provided in § 29.41-2.

§ 29.22 (d)-6 *Change from elective inventory method.* If the taxpayer is granted permission by the Commissioner to discontinue the use of the elective method of taking inventories, and thereafter to pursue some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the elective method by reason of the taxpayer's failure to conform to the requirements detailed in § 29.22 (d)-2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken:

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

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

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

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

§ 29.22 (d)-7 *Involuntary liquidation and replacement.* (a) If prevailing war conditions beyond the control of the taxpayer should render it impossible during the period of the war for a taxpayer using the elective inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner at the time of filing his income tax return for the year of the liquidation that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 22 (d) (6), and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, to an adjustment of net income for the year of liquidation to the extent of the difference between the replacement costs incurred and the original inventory cost of the base stock inventory liquidated. If the replacement costs exceed such inventory costs, the net income of the taxpayer otherwise computed shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, net income other-

wise computed shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected by the Commissioner or credited or refunded to the taxpayer without interest.

(b) The statutory provisions affording recognition to the involuntary character of inventory decreases which become apparent in war years and authorizing for tax purposes a replacement of the items of merchandise so liquidated are limited in their application to liquidations occurring in taxable years beginning prior to January 1, 1948, and to inventory replacements effected in taxable years ending prior to January 1, 1951.

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

(d) If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decreases suffered during war years, he must so elect at the time of filing his income tax return for the year reflecting the decrease. In making such election, the taxpayer shall attach to his return and make a part thereof a statement setting forth the following matters: (1) the wish of the taxpayer to invoke the involuntary liquidation and replacement provisions; (2) a detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended; (3) the circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved; (4) detailed proof of such circumstances to the extent that they may not be the subject matter of common knowledge; and (5) a full description of what efforts were made on the part of the taxpayer to effect replacement during the taxable year and the result of such efforts.

(e) The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease, and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its prospective replacement, and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening and subsequent years to the extent that such prior, intervening, and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carry-backs, and in intervening and subsequent taxable years by reason of adjustments in carry-overs. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's returns for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such

claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized.

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

(g) The goods reflected in any inventory increase in a year subsequent to a year of inventory liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced. To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

(h) In some cases it may appear at the time of the filing of the income tax return for the year of replacement, or at the time of the Commissioner's examination of such return, that an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some intervening taxable years, is prevented by the running of the statute of limitations, by the execution of a closing agreement, by virtue of a court decision which has become final, or by reason of some other provision or rule of law other than section 3761 relating to compromises and other than the inventory replacement provisions. The adjustments provided for in connection with the involuntary liquidation and replacement of inventory shall nevertheless be made, but only if, within a period of three years after the date of the filing of the income tax return for the year of replacement, a notice of deficiency is mailed or a claim for refund is filed. No credit or refund will be allowed under such circumstances, whether within or without such 3-year period, in the absence of a claim for refund duly filed; nor will a resulting deficiency be assessed or collected under section 272 (d) relating to waivers of restrictions. The issuance of the statutory notice of deficiency or the filing of a claim for refund are statutory conditions upon which depend the provisions of subparagraph (E) of the liquidation and replacement enactment. The adjustment authorized by subparagraph (E) is limited further to the tax attributable solely to the replacement adjustments. The amount of the adjustment shall be computed by reference to the amount of the tax previously determined, and without regard to factors affecting the taxable year involved to which no effect was given in such prior determination. The tax previously determined shall be ascertained in accordance with the principles stated in section 734 (d) and those sections of the regulations prescribed thereunder. Any deficiency paid or any overpayment credited or refunded under these circumstances shall not be subject to recovery on a claim for refund or a suit for the recovery of an erroneous refund in any case in which such claim or suit is based upon factors other than those giving rise to the adjustments made.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5364, 9 F. R. 4574, T. D. 5645, 13 F. R. 4256]

§ 29.22 (k)-1 *Alimony and separate maintenance payments; income to former wife*—(a) *In general.* (1) Section 22 (k) provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or legally separated under a court order or decree. For convenience, the payee spouse will hereafter in the regulations of this section be referred to as the "wife" and the spouse from whom she is divorced or legally separated as the "husband." See section 3797 (a) (17). In general, section 22 (k) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after the decree of divorce or of separate maintenance. Such periodic

payments may be received from either of the two following sources:

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

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

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

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

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

The periodic payments received by the wife attributable to property so transferred and includible in her income are not to be included in the gross income of the husband. See also § 29.171-1 in cases where such periodic payments are attributable to property held in trust.

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

Example 1. W sues H for divorce in 1942. The court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1942, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 22 (k), but the $200 a month received during the balance of 1942 by W is includible in her income for 1942. Under section 23 (u), H is entitled to deduct such $200 payments from his income.

Example 2. W files suit for divorce from H. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H makes a legally binding promise in writing to W to pay to her $200 a month if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered prior to 1942. During 1942, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 22 (k). Under section 23 (u), H is entitled to a deduction of $2,400 from his gross income.

Example 3. H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W $200 a month for her life. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 22 (k) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if, at the time of the divorce, reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce, section 22 (k) would require the inclusion of the payments received by W after the decree in her income for taxable years beginning after December 31, 1941. (As to including such payments in the wife's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, see § 29.171-1.)

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

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

(b) *Alimony income attributable to property.* (1) The full amount of pe-

riodic payments received under the circumstances described in section 22 (k) is required to be included in the gross income of the recipient whether such amounts are derived, in whole or in part, from income received or accrued by the source to which such payments are attributable. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the obligor husband from his income or capital. For example, if in order to meet an alimony obligation of $500 a month, the husband purchases or assigns for the benefit of his former wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 22 (b) (2) (A) and § 29.22 (b) (2)-4. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his former wife in discharge of his alimony obligation under the divorce decree, the $5,000 received annually is, under section 22 (k), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(2) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 22 (k) applies is includible in the wife's income, regardless of whether such payments are made out of trust income. This rule applies even though under the law applicable to taxable years beginning before January 1, 1942, only the income of a trust for the benefit of the divorced wife was taxable to her. Such periodic payments are to be included in the wife's income under section 22 (k) and are to be excluded from the husband's income, even though the income of the trust would otherwise be includible in his income under section 22 (a), section 166, section 167, or any other section of the Code or the regulations in this part. As to periodic payments received by a former wife attributable to property in trust in cases to which section 22 (k) does not apply because the husband's obligation is not specified in the decree or an instrument incident thereto, see section 171 (a) and § 29.171-1.

(3) Section 22 (k) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident thereto, which interest originally belonged to the wife. It will apply, however, if she received such interest from the husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfers securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife in discharge of the husband's obligation under the decree, or instrument incident thereto, is taxable to her under section 22 (k), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income, as provided in section 162. If, however, the husband's transfer of an interest in his property to his wife, preliminary to a transfer of such property in discharge of his obligation, is made in an attempt to avoid the application of section 22 (k) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation. In such a case, section 22 (k) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see § 29.22 (b) (2)-4.

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

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

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

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

Example (2). A divorce decree in 1940 provides that H is to pay W $20,000 each year for the next 5 years, beginning with the date of the decree and then $5,000 each year for the next 10 years. Assuming the wife makes her returns on the calendar year basis, each payment received in 1942, 19433, and 1944 is a periodic payment under section 22 (k), but only to the extent of 10 percent of the principal sum of $150,000. Thus for such taxable years, only $15,000 of the $20,000 received is includible under section 22 (k) in the wife's income and is deductible by the husband under section 23 (u). For the years 1945–1954, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

Example (3). Under the terms of a separation agreement incident to divorce granted in December 1941, H agrees to pay W $500 on the 1st day of each month, beginning with the month after the decree, for 12 years. W makes her income tax returns on the calendar year basis while H makes his returns on the basis of the fiscal year ending June 30. H makes the promised payments in 1942 and, in addition, on December 31, 1942, pays W $1,500 as an advance payment of installments for the next three months. In the calendar year 1943, H makes no payments at all because of financial straits. On January 1, 1944, H inherits $15,000, which he immediately pays to W in satisfaction of not only his back alimony installments for the last 9 months of 1943 but also his alimony installments for the next 21 months. The results as to H and W are as follows:

As to W: In the calendar year 1942, W received $7,500. Since 10 percent of $72,000 (the principal sum) is $7,200, only $7,200 of the $7,500 so received is includible in her income for 1942. For 1943, nothing is includible in her income under section 22 (k). In 1944, W received $15,000. Of this amount $4,500 is in payment of back installments and, therefore, is includible without limitation in her income for 1944. Of the balance of $10,500, only $7,200 is includible in her income for 1944.

As to H: For the taxable year ended June 30, 1942, H paid $3,000, all of which is deductible by H since it was paid in the wife's first taxable year beginning after December 31, 1941. In the taxable year ended June 30, 1943, H paid W $4,500, which, not being in excess of 10 percent of the principal sum, is deductible for such year. In his taxable year ended June 30, 1944, H paid $15,000, of which $11,700 (the sum of $4,500 and $7,200) is deductible.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 11, T. D. 5600, 13 F. R. 577]

§ 29.22 (m)-1 *Services of child.* (a) For taxable years beginning after December 31, 1943, compensation for personal services of a child shall, regardless of the

provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and reflected in the return rendered by or for such child if the gross income for the taxable year amounts to $500 or more. The income of a minor child, whether more or less than $500, is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see § 29.51–3. Any tax assessed against the child, to the extent of the amount attributable to income included in the gross income of the child solely by reason of section 22 (m) (1), if not paid by the child, shall, for the purposes of all provisions of law relating to the assessment and collection of the tax imposed by chapter 1, be considered as having also been properly assessed against the parent. In any case in which the earnings of the child are included in the gross income of the child solely by reason of section 22 (m) (1), the parent's liability is an amount equal to the amount by which the tax assessed against the child has been increased by reason of the inclusion of such earnings in the gross income of the child. Thus, if for 1944 the child has income of $1,000 from investments and of $3,000 for services rendered, and the latter amount is includible in gross income of the child under section 22 (m) (1), and the child has no wife or dependents, the tax liability determined under Supplement T is $741. If the child had only the investment income of $1,000, his tax liability would be $95. If the tax of $741 is assessed against the child, the difference between $741 and $95, or $646, is the amount of such tax which is considered to have been properly assessed against the parent.

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

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

[T. D. 5425, 10 F. R. 11]

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

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

(c) The deductions specified in section 22 (n) for the purpose of computing adjusted gross income are: (1) Deductions allowable under section 23, which are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee; (2) deductions allowable by section 23 which constitute expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee; (3) deductions allowable by section 23 (other than expenses of travel, meals, and lodging while away from home) which consist of expenses paid or incurred in connection with the performance of services as an employee under a reimbursement or other expense-allowance arrangement with his employer; (4) deductions allowable un-

der section 23 which are attributable to rents and royalties; (5) deductions for depreciation and depletion allowable under section 23 (l) and (m) to a life tenant of property or to an income beneficiary of property held in trust; and (6) deductions which are allowable under section 23 as losses from the sale or exchange of property.

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

(e) Traveling expenses paid or incurred by an employee in connection with his employment while away from home which are deductible from gross income in computing net income may be deducted from gross income in computing adjusted gross income. Among the items included in traveling expenses are charges for transportation of persons or baggage, expenditures for meals and lodging, and payments for the use of sample rooms for the display of goods. See § 29.23 (a)-2.

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

[T. D. 5425, 10 F. R. 12]

§ 29.23 (a)-1 *Business expenses.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (z), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a), see § 29.23 (a)-13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See § 29.22 (a)-5.) Among the items included in business expenses are management expenses, commissions (but see § 29.24-2, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 29.23 (a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

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

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

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

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

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

(e) 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.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

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

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

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

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

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

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services rendered, but that the excessive payments are a distribution of earnings upon the stock. (2) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

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

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

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

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

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

§ 29.23 (a)-10 *Rentals.* (a) If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. 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.

(b) In cases in which the lease contains an unexercised option of renewal, the matter of spreading such depreciation or amortization over the term of the original lease, together with the renewal period or periods, depends upon the facts in the particular case. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease or the cost of improvements shall be spread only over the number of years the lease has to run, without taking into account any right of renewal. However, if the taxpayer for any taxable year ending prior to December 31, 1939, has been allowed such depreciation or amortization on the basis of spreading the cost or other basis of such lease or improvements over the number of years the lease has to run, including any exercised or unexercised renewal period or periods, and such taxable year has been closed on that basis and the tax for that year cannot be redetermined, then the taxpayer may for subsequent taxable years take deductions on such basis if within 90 days after the approval of T. D. 4957 (4 F. R. 4809), December 6, 1939 or within such later period as may be specified by the Commissioner, he files Form 969, in duplicate, with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, signifying his election to have deductions in respect of such items determined upon such basis, and expressly waives his right to claim or receive the benefits of any reduction in his tax liability which would result from the allowance of deductions for such items on the basis of only the number of years the lease has to run, without taking into account any right of renewal, or on any basis other than that set forth in his election. If, in any case, the life of the improvements is less than the number of years the lease has to run, including the renewal period if properly to be considered, the deduction for depreciation with respect to such improvements shall be spread only over such life.

§ 29.23 (a)-11 *Expenses of farmers.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see § 29.41-2), be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with § 29.22 (a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the ex-

penses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also §§ 29.22 (a)-7, 29.23 (e)-5, and 29.23 (l)-10.)

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

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

(b) The limitations provided in section 23 (a) (1) and this section apply only to payments which are in fact contributions or gifts to organizations described in section 23 (q). For example, payments by a street railway corporation to a local hospital (which is a charitable organization within the meaning of section 23 (q)) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the corporation's employees are not contributions or gifts within the meaning of section 23 (q) and may be deductible under section 23 (a) if the requirements of that section are otherwise satisfied. Donations to organizations other than those described in section 23 (q) which bear a direct relationship to the corporation's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses. For example, a street railway corporation may donate a sum of money to an organization (of a class not referred to in section 23 (q)) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its cars.

§ 29.23 (a)-14 *Expenditures for advertising or promotion of good will.* A corporation which has, for the purpose of computing its excess profits credit, elected under section 733 to charge to capital account expenditures for advertising or the promotion of good will which may be regarded as capital investments and which were deducted for taxable years beginning after December 31, 1935, and prior to January 1, 1940, may not deduct similar expenditures for the taxable year. Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct for such later taxable years may not be regarded as capital investments under the provisions of the regulations prescribed under section 733. For rules for determining what expenditures for advertising or the promotion of good will may be regarded as capital investments, and for information required to be submitted with respect to such expenditures, see article 733-2 of Regulation 109 (26 CFR, 1941 Supp., 30.733-2).

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

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of in-

come which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

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

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

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

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

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

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

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

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

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under this section, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see § 29.162-1 for disallowance of such deductions to an estate where such items are claimed as a deduction under section 812 (b) in computing the net estate subject to the estate tax.

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

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

will be held by him for the production of income.

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5331, 9 F. R. 1612, T. D. 5513, 11 F. R. 5346]

§ 29.23 (a)-16 *Wage and salary payments in contravention of wage and salary limitations not deductible.* In any case in which it is certified to the Commissioner, by an administering agency authorized to act in accordance with 32 CFR, 1943 Cum. Supp., Supps., 4001.15 (regulations of the Economic Stabilization Director, as amended), that a wage or salary payment for which a deduction would otherwise be allowable has been made in contravention of the act of October 2, 1942, entitled "An act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes" (56 Stat. 765–768; 50 U. S. C., App., Sup., secs. 961–971) as amended, or of the regulations, orders or rulings promulgated thereunder, the entire amount of such payment shall be disallowed as a deduction and not merely an amount representing the increase or decrease made in such wage or salary in contravention of such Act or regulations, orders, or rulings promulgated thereunder, except that if the administering agency in the light of extenuating circumstances determines and certifies to the Commissioner that a lesser amount of such payment be disallowed as a deduction, then only such lesser amount shall be disallowed as a deduction. Such a payment will not be allowed for this purpose notwithstanding that the same payment is also disallowed (a) for the purpose of determining costs or expenses of an employer for the purpose of some other law or regulation, either heretofore or hereafter promulgated, including the Emergency Price Control Act of 1942, or any maximum price regulation thereof; or (b) for the purpose of determining costs or expenses under any contract made by or on behalf of the United States.

[T. D. 5446, 10 F. R. 3008]

§ 29.23 (b)-1 *Interest.* (a) Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, Panama Canal loan 3 percent bonds, or (in the case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax, is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (1) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by chapter 1, or (2) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes imposed by chapter 1, is deductible in accordance with the general rule.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

(c) Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from

gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, section 121.) In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).
[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.23 (c)–1 *Taxes*—(a) *In general.* Subject to the exceptions stated in this section and §§ 29.23 (c)–2 and 29.23 (c)–3, taxes imposed by the United States, any State or Territory, or political subdivision of either, possessions of the United States, or foreign countries, are deductible from gross income for the year in which paid or accrued (see section 43). Estate, inheritance, legacy, succession, and gift taxes and Federal income taxes are not deductible from gross income. The Federal war-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, section 702 of the Revenue Act of 1934, and subchapter E of chapter 2 are not deductible from gross income. Income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States are deductible from gross income in cases where the taxpayer does not choose to take to any extent for the taxable year the benefits of section 131 (relating to credit for taxes of foreign countries or possessions of the United States). (See the last sentence of section 131 (a).) See generally §§ 29.131–1 to 29.131–9, as to tax credits. Postage is not a tax. Amounts paid to States or Territories under secured debts laws in order to render securities tax exempt are deductible. Automobile license fees are ordinary taxes. In general taxes are deductible only by the person upon whom they are imposed. As to tax paid at the source on interest from tax-free covenant bonds, see section 143 (a) (3).

(b) *State and local sales taxes.* (1) Amounts representing sales taxes paid by a purchaser of services or tangible personal property are deductible by such purchaser as taxes, provided they are not paid in connection with his trade or business. The fact that, under the law imposing it, the incidence of the sales tax does not fall on the purchaser is immaterial. The requirement of section 23 (c) (3) that the amount of the tax must be separately stated will be deemed complied with where it clearly appears that the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purposes of this section, that the purchaser be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. Where the law imposing the sales tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the sales tax was separately stated at the time paid by the purchaser.

(2) As used in this section the term "sales tax" means a tax imposed by any State, Territory, District, or possession of the United States, or any political subdivision thereof upon persons engaged in selling tangible personal property at retail, which is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of such property sold. The term also includes a tax imposed by such authorities upon persons engaged in furnishing services at retail which is measured by the gross receipts for furnishing such services.
[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.23 (c)–2 *Federal duties and excise taxes.* Federal import or tariff duties, business, license, privilege, excise, and stamp taxes, not described in subparagraph (A), (B), (D), or (E) of section 23 (c), paid or accrued within the taxable year are deductible as taxes, except for taxable years beginning after December 31, 1943, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which

they are paid, in which case they cannot be separately deducted. The fact that such taxes are not deductible as taxes under section 23 (c) for taxable years beginning after December 31, 1943, does not prevent a deduction therefor under section 23 (a) provided they represent ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, or, in the case of an individual, for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. (See § 29.23 (a)-1.)

[T. D. 5371, 9 F. R. 5111]

NOTE: The following statement was published Dec. 2, 1946, 11 F.R. 14159, pursuant to section 3 (a)-3 of the Administrative Procedure Act. Reference is made to that portion of I.T. 3806, 1946 I.R.B. No. 13, 22, which reads as follows:

(2) Federal stamp taxes paid on transfers or conveyances of securities or real estate upon sales thereof as a trader or other nondealer are selling costs or offsets against selling prices to be taken into account only in determining (net) amounts realized and gains or losses under section 111 of the Code on the sales;

Prior to the publication of I.T. 3806, the Bureau had ruled that such taxes were deductible in their entirety in the case of traders and other nondealers and need not be treated as offsets against the selling price. The prior position of the Bureau has been publicized by various commercial tax services and, as a consequence, was relied upon by many taxpayers in preparing and filing their returns for the years 1944 and 1945.

Where, with respect to returns filed for taxable years ending prior to the publication of I.T. 3806, Federal stamp taxes, paid on transfers or conveyances of securities or real estate upon sales thereof as a trader or other nondealer, were deducted in their entirety rather than as offsets against the selling prices, it will be the administrative policy not to disturb such treatment. (Sec. 3791 (b) of the Internal Revenue Code; 26 U.S.C. 3791 (b)).

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

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

§ 29.23 (e)-1 *Losses by individuals.* (a) Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (1) incurred in the taxpayer's trade or business, or (2) incurred in any transaction entered into for profit, or (3) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or ex-

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changes of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

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

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

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

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

Example (1). Residential property was purchased by a taxpayer in 1932 for use as his personal residence at a cost of $25,000, of which $15,000 was allocable to the building. The property was so used by the taxpayer until January 1, 1939. From that date to January 1, 1942, when the property was sold, it was rented by the taxpayer. The fair market value of the property at the time it was rented on January 1, 1939, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1939. The property was sold on January 1, 1942, for $16,000. The loss from the sale allowable as a deduction, except as limited by section 117, is $4,200, computed as follows:

Cost of property in 1932	$25,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $12,000, value of building when converted to business use)	1,800
	23,200
Selling price of property	16,000
Loss computed as provided in section 111	7,200
Value of property at time it was rented on January 1, 1939	22,000
Less proper adjustment for depreciation	1,800
	20,200
Selling price of property	16,000
Portion of $7,200 loss which is deductible except as limited by section 117	4,200

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

Cost of property in 1932	$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $10,000, cost of building)	1,500
	18,500
Selling price of property	16,000
Loss computed as provided in section 111	2,500
Deductible loss, except as limited by section 117	2,500

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

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

§ 29.23 (e)-3 *Loss of useful value.* (a) When, through some change in business conditions, the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and §§ 29 113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-(2) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in second 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

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

(c) In cases in which depreciable property, is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113 (b) and §§ 29.113 (a) (14)-1, and 29.113 (b) (1)-1 to 29.113 (b) (3)-2) and its salvage value and/or amount realized upon its disposition may be allowed subject to the limitations provided in the Internal Revenue Code upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depreciation.

(d) In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the basis of the asset (adjusted as provided in section 113 (b) and §§ 29.113 (a) (14)-1, and 29.113 (b) (1)-1 to 29.113 (b) (3)-2) less its salvage value is allowable upon its retirement. (See §§ 29.23 (l)-1 to 29.23 (l)-10.)

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.23 (e)-4 *Shrinkage in value of stocks.* A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss

merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and §§ 29.113 (b) (1)-1 to 29.113 (b) (3)-2, is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness. Federal or State authorities incident to the regulation of banks and certain other corporations may require that stock be charged off as worthless or written down to a nominal value. If, in any such case, the basis of the requirement is the worthlessness of the stock, such charging off or writing down will, for income tax purposes, be considered prima facie evidence of worthlessness; but if the charging off or writing down is due to market fluctuations, or if no reasonable attempt has been made to determine worthlessness, no deduction for income tax purposes of the amount so charged off or written down can be allowed. For dealers in securities, see § 29.22 (c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally, including stocks and bonds, see section 117.

§ 29.23 (e)-5 *Losses of farmers.* Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. A farmer engaged in raising and selling stock, such as cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used. If livestock has been purchased after February 28, 1913, for any purpose, and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such livestock, less any depreciation allowable as a deduction in respect of such perished livestock, may be deducted as a loss if the loss is not compensated for by insurance or otherwise. The actual cost of other property (with proper adjustment for depreciation) which is destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss. If reimbursement is made by a State or the United States in whole or in part on account of stock killed or other property destroyed in respect of which a loss was claimed for a prior year, the amount received shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasture, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss. If gross income is ascertained by inventories, no deduction can be made for livestock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of livestock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. As to losses claimed as deductions for estate tax purposes, see § 29.23 (e)-1. See also §§ 29.22 (a)-7, 29.23 (a)-11, and 29.23 (1)-10.

§ 29.23 (f)-1 *Losses by corporations.* Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible in so far as not prohibited or limited by sections 23 (g), 23 (h), 24 (b), 112, 117, 118, and 251. The provisions of §§ 29.23 (e)-1 to 29.23 (e)-5, and § 29.23 (i)-1 are in general applicable to corporations as well as individuals. See section 223 as to deductions by foreign corporations. For special provisions with respect to war losses, see section 127.

§ 29.23 (g)-1 *Capital losses.* (a) Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (f) for losses sustained on the

sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. Losses sustained by virtue of securities becoming worthless during the taxable year are, under section 23 (g), made subject to the limitations provided in section 117 with respect to sales or exchanges, provided the securities are "capital assets" as that term is defined in section 117 (a) (1). For purposes of computing the net income of any taxpayer, such losses are to be considered as being sustained from the sale or exchange of the securities on the last day of the taxable year, irrespective of when during the taxable year such securities actually became worthless. Section 23 (g) does not apply to securities which are deemed destroyed or seized under section 127, relating to war losses.

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

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

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.23 (g)-2 *Loss on stock of affiliate.* If a taxpayer is a domestic corporation and is affiliated, within the definition in section 23 (g) (4), with another corporation, the stock in such affiliated corporation owned by the taxpayer is not considered to be a "capital asset" of the taxpayer for the purpose of determining the loss from the worthlessness of such stock within the provisions of section 23 (g) (2) and § 29.23 (g)-1. For the purposes of section 23 (g) (2), section 23 (g) (4), § 29.23 (g)-1, and this section a corporation shall be deemed to be affiliated with the taxpayer only if all the following factors are present:

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

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

(c) The taxpayer is a domestic corporation.

Example. Corporation P, a domestic manufacturing corporation which makes its income tax returns on the calendar year basis, owns 100 percent of each class of the stock of Corporation S, and, in addition, 4 percent of the common stock (the only class of stock) of Corporation R which it acquired in 1936. Corporation S, a domestic manufacturing corporation which makes its income tax returns on the calendar year basis, owns 96 percent of the common stock of Corporation R which it acquired in 1934. It is established that the stock of Corporation R which has from its inception derived all its gross income from manufacturing operations, became worthless during 1942. Since Corporation P does not own directly at least 95 percent of the stock of Corporation R, and therefore for the purposes of section 23 (g) (4) and this section is not affiliated with Corporation R, the stock of such corporation is a capital asset. Any loss upon such stock, under section 23 (g) (2), will be considered to be a loss from the sale or exchange of a capital asset. Since such stock was held for more than six months, such loss shall be considered a long-term capital loss under section 117. (See also section 117 (d).) Since Corporation R is deemed to be affiliated with Corporation S for the purposes of section 23 (g) (4) and this section, the stock of Corporation R is not a "capital asset" in the hands of Corporation S for the purposes of section 23 (g) (2) and § 29.23 (g) 1. Consequently, in computing the net income of Corporation S for 1942, any loss upon such stock, under section 23 (f), will be deducted as an ordinary loss and will not be circumscribed by the provisions of section 23 (g) or section 117.

(d) With respect to losses on bonds and similar securities, as defined in section 23 (k) (5), of a corporation affiliated

with the taxpayer, as provided in such section, see § 29.23 (k)-4.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5376, 9 F. R. 6057]

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

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

§ 29.23 (k)-1 *Bad debts.* (a) Bad debts may be treated in either of two ways:

(1) By a deduction from income in respect of debts which become worthless in whole or in part, or

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

(b) Taxpayers were given a similar option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) While ascertainment of worthlessness and charge-off during the taxable year (which were prerequisite to deduction of a bad debt under the law at that time) are no longer required for the allowance of a debt which becomes wholly worthless, the method used in the return for 1921 must be used in returns for all subsequent years unless permission is granted by the Commissioner to change to the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also § 29.23 (k)-5.)

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

(d) Where the surrounding circumstances indicate that a debt is worthless

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

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5376, 9 F. R. 6057]

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

§ 29.23 (k)-3 *Uncollectible deficiency upon sale of mortgaged or pledged property.* (a) If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it has become

wholly worthless or is charged off as partially worthless. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

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

§ 29.23 (k)–4 *Worthless bonds and similar obligations.* (a) Except as otherwise provided in section 23 (k) (5), no deduction is allowable under section 23 (k) (1) to any taxpayer (other than a bank as defined in section 104) with respect to a debt evidenced by a security which has become worthless in whole or in part. If a security is a capital asset and becomes worthless during the taxable year, a deduction for the loss resulting therefrom is allowable under section 23 (k) (2) to a taxpayer other than a bank. Such a loss, however, is made subject to the limitations provided in section 117 with respect to sales or exchanges. For the purposes of computing the net income of any taxpayer, other than a bank as defined in section 104, such a loss is to be considered as being sustained from the sale or exchange of the security on the last day of the taxable year, irrespective of when during the taxable year such security actually became worthless. Except in the case of a bank as defined in section 104, no deduction is allowable under section 23 (k) with respect to a debt evidenced by a security, as defined in section 23 (k) (3), which is recoverable only in part. Section 23 (k) (2) does not apply to securities which are deemed destroyed or seized under section 127, relating to war losses.

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

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

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

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

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

Example (2). If the facts in example (1) are the same except that because of the financial condition of the X Corporation the

debt evidenced by its bonds became recoverable only in part, no deduction is allowable to A under either section 23 (k) (1) or (2) with respect to the uncollectible part of such debt.

(f) Under section 23 (k) (5), bonds, debentures, notes or certificates, or other evidences of indebtedness to pay a fixed or determinable sum of money, issued with interest coupons or in registered form by any corporation affiliated with the taxpayer, shall not be deemed capital assets of the taxpayer for the purposes of section 23 (k) (2) or as a debt (evidenced by a security) for the purposes of this section; and the provisions of section 23 (k) (1) and of paragraphs (a) and (b) of § 29.23 (k)-1 shall apply with respect to such debts except that no deduction shall be allowed to the taxpayer with respect to any such debt which is recoverable only in part.

(g) For the purpose of this section, a corporation is deemed to be affiliated with the taxpayer only if the taxpayer owns at least 95 percent of each class of the stock of such corporation, if more than 90 percent of the aggregate of the gross incomes of such corporation for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from the sales or exchanges of stocks and securities, and if the taxpayer is a domestic corporation.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5376, 9 F. R. 6057]

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

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

§ 29.23 (k)-6 *Non-business bad debts.* (a) In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than 6 months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this section applicable in the case of a loss resulting from a security as defined in section 23 (k) (3). A non-business debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23 (k) (3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under paragraph (1) of that section.

(b) The character of the debt for this purpose is not controlled by the circum-

stances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the nonbusiness debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the nonbusiness debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the nonbusiness debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.23 (l)-1 *Depreciation.* A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under § 29.23 (a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, will be allowed to the remainderman. In the case of property held in trust, the allowable deduction is to be appportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust

income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. For deduction with respect to the amortization of emergency facilities, in lieu of the deduction for depreciation, see sections 23 (t) and 124.

§ 29.23 (l)-2 *Depreciable property.* The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under § 29.23 (a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See § 29.23 (a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under § 29.23 (a)-15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and custumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

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

§ 29.23 (l)-4 *Capital sum recoverable through depreciation allowances.* The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113 (a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. (See section 113 (b).) In the case of the acquistion on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, buildings and land, the capital sum to be replaced is limited to an amount which bears the same proportion to the lump price as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which has been the subject of deductions for amortization under sections 214 (a) (9) and 234 (a) (8) of the Revenue Acts of 1918 and 1921, depreciation deductions will be computed after

the close of the amortization period upon the cost or other basis of such property after the amortization allowance has been deducted. No depreciation deduction will be allowed in the case of property which has been amortized to its scrap value and is no longer in use.

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

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

Example. An asset was purchased January 1, 1937, at a cost of $10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1937 to 1941 as follows:

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

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

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

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

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

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

§ 29.23 (l)-7 *Depreciation of patent or copyright.* In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost or other basis of the patent or copyright. The allowance should be computed by an apportionment of the cost or other basis of the patent or copyright over the life of the patent or copy-

right since its grant, or since its acquisition by the taxpayer, or in the case of a copyright, since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorneys' fees, development or experimental expenses, etc., actually paid. Depreciation of a copyright can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration, such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the basic date and the date when it legally expires may be deducted. The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.

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

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

§ 29.23 (l)-10 *Deprcciation in case of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on livestock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with § 29.22 (a)-7. Such depreciation should be based on the cost or other basis and the estimated life of the livestock. If such livestock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. (See also §§ 29.23 (a)-11 and 29.23 (e)-5.)

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

Under such provisions, the owner of an economic interest in mineral deposits

or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed with respect to any timber which the owner has disposed of under any form of contract by virtue of which the owner retains an economic interest in such timber, if such disposal is considered a sale of the timber under section 117 (k) (2) of the Code. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. (But see § 29.115-6.) The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See § 29.23 (l)-1.)

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

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

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

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

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

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

(f) The term "gross income from the property", as used in sections 114 (b) (3) and 114 (b) (4) (A) and §§ 29.23 (m)-1 to 29.23 (m)-19, means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

In the case of a crude mineral product other than oil and gas, "gross income from the property", as used in section 114 (b) (4) (A) means the gross income from mining. The term "mining" as used in §§ 29.23 (m)-1 to 29.23 (m)-19 includes not only the extraction of ores or minerals from the ground but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products.

If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described in this paragraph) before sale, "gross income from the

property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

The term "ordinary treatment processes", as used in §§ 29.23 (m)-1 to 29.23 (m)-19, shall include the following:

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

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

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

(4) In the case of lead, zinc, copper, gold, silver or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation, or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore. The furnacing of quicksilver ores is included in the term "ordinary treatment processes". The following processes are not included in the term "ordinary treatment processes": electrolytic deposition, roasting, thermal or electric smelting, refining, or substantially equivalent processes.

In case any of the ordinary treatment processes are not applied in the immediate vicinity of the mining district in which the mine is located, costs incurred for transportation to the processing location and, if transported by the taxpayer, the proportionate profits attributable to transportation, should be subtracted from the sale price of the product to determine "gross income from the property." If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to § 29.23 (m)-10 (e).

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and §§ 29.23 (m)-1 to 29.23 (m)-19, means the "gross income from the property" as defined in paragraph (f) of this section less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) of this sec-

tion in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (f) of this section, deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (f) of this section and (2) the additional activities, taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (f) of this section bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (f) of this section shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

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

(i) "The property," as used in section 114 (b) (2), (3), and (4) and §§ 29.23 (m)-1 to 29.23 (m)-19, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5413, 9 F. R. 13103, T. D. 5458, 10 F. R. 7335, T. D. 5461, 10 F. R. 8652]

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

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

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

(d) In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (1) amounts representing the cost or value of the land for purposes other than mineral production, (2) the amount recoverable through depreciation and through deductions other than depletion, and (c) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in § 29.23 (m)-16, are recoverable through depletion.

(e) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the depletion allow-

ance (without reference to percentage depletion) in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in closed or rock pressure during the taxable year and the denominator of which is equal to the expected total decline in closed or rock pressure from the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

§ 29.23 (m)-3 *Computation of depletion of mines (other than metal, coal, bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, ball, sagger, and china clay, phospate rock, rock asphalt mines, or trona, bentonite, gilsonite, thenardite, potash, or sulphur mines or deposits) on basis of discovery value.* (a) The basis on which depletion is to be computed in the case of mines, except those specified in the next succeeding sentence, discovered by the taxpayer after February 28, 1913, is the fair market value of the property at the date of discovery or within 30 days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to cost. Such basis may not be used in the case of the following: metal, coal, fluorspar, ball and sagger clay, rock asphalt, or sulphur mines with respect to taxable years beginning after December 31, 1941, flake graphite mines with respect to taxable years beginning after December 31, 1942; vermiculite, beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene or barite mines, or potash mines or deposits including potash salts in solution with respect to taxable years beginning after December 31, 1943; or bauxite, pyrophyllite, china clay, phosphate rock, trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine) mines or deposits for taxable years beginning after December 31, 1946. The value must be equitably apportioned between the owners of the economic interests therein. For the method of determining whether a discovery has been made, see § 29.23 (m)-14. For the method of determining the fair market value, see § 29.23 (m)-7.

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

(c) The depletion allowance based on discovery value under this section shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion be less than it would be if computed without reference to discovery value. For definition of "net income of the taxpayer (computed without allowance for depletion) from the property," see § 29.23 (m)-1 (g).

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5645, 13 F. R. 4256]

§ 29.23 (m)-4 *Computation of depletion based on a percentage of income in case of oil and gas wells.* Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent

of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see § 29.23 (m)-1 (f) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

§ 29.23 (m)-5 *Computation of depletion based on percentage of income in case of coal mines, metal mines, bauxite mines, fluorspar mines, flake graphite mines, vermiculite mines, beryl mines, feldspar mines, mica mines, talc (including pyrophyllite) mines, lepidolite mines, spodumene mines, barite mines, ball, sagger, and china clay mines, phosphate rock mines, rock asphalt mines, trona, bentonite, gilsonite, thenardite, and potash and sulphur mines or deposits.* (a) Under section 114 (b) (4) (A) a taxpayer may deduct for depletion an amount equal to 5 percent of the gross income from the property during any taxable year in the case of coal mines; an amount equal to 15 percent of the gross income from the property during any taxable year in the case of metal, fluorspar, ball and sagger clay, or rock asphalt mines, and during any taxable year beginning after December 31, 1942, in the case of flake graphite mines, and during any taxable year beginning after December 31, 1943, in the case of vermiculite, beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene, or barite mines, or potash mines or deposits including potash salts in solution, and during any taxable year beginning after December 31, 1946, in the case of bauxite, pyrophyllite, china clay, or phosphate rock mines, or trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine) mines or deposits; and an amount equal to 23 percent of the gross income from the property during any taxable year in the case of sulphur mines or deposits; but such deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see § 29.23 (m)-1 (f) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5645, 13 F. R. 4256]

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

§ 29.23 (m)-7 *Determination of fair market value of mineral properties, including oil and gas properties.* (a) If the fair market value of the property at a specified date is to be determined for the purpose of ascertaining the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for

purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight, (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the mineral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

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

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

(d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued separately. The mineral content of a deposit shall be determined in accordance with § 29.23 (m)-9. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or

reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is influenced by the natural decline in pressure and flow, and also by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as defined in §§ 29.23 (m)-15 and 29.23 (m)-16. and deductions for depreciation and depletion, but including cost of repairs. For definitions of "development expenses" and "operating expenses" in the case of oil and gas wells, see § 29.23 (m)-16. This cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

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

(f) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any mineral property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral property in fee simple.

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

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

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

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

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

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

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

§ 29.23 (m)-10 *Depletion; adjustments of accounts based on bonus or advanced royalty.* (a) If a bonus in addition to royalties is received upon the grant of rights in mineral property, there shall be allowed to the payee as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance.

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

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

(d) In lieu of the treatment provided for in paragraphs (a) and (b) of this section, the owner of an economic interest in oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the owner of an economic interest in sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 23 percent, 15 percent, and 5 percent, respectively, of the amount thereof; but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. A deple-

tion deduction in respect of any bonus or advanced royalty from the property in the amount of 15 percent of such bonus or royalty may be taken by the owner of an economic interest in fluorspar, ball and sagger clay, or rock asphalt mines with respect to any taxable year, may be taken by the owner of an economic interest in a flake graphite mine with respect to taxable years beginning after December 31, 1942, may be taken by the owner of an economic interest in vermiculite beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene, and barite mines, and potash mines or deposits including potash salts in solution with respect to taxable years beginning after December 31, 1943, and may be taken by the owner of an economic interest in bauxite, pyrophyllite, china clay, or phosphate rock mines, or trona, bentonite, gilsonite, or thenardite (from brines or mixtures of brine) mines or deposits with respect to taxable years beginning after December 31, 1946; but such depletion deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

(e) If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

(2) As deductions from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

(f) The option contained in paragraph (e) of this section shall apply only to advanced royalties paid or accrued in taxable years ending on or after December 31, 1939. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrue. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with paragraph (e) (2) of this section. Any election made under this section is binding for all subsequent years and the taxpayer must treat all advanced royalties paid or accrued in such subsequent years in the same manner.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5645, 13 F. R. 4256]

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

(b) If the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with §§ 29.23 (m)-2, 29.23 (m)-3, 29.23 (m)-4, or 29.23 (m)-5; or the amounts of the depletion and depreciation so computed shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deductions as may thereafter be allowable under section 114 (b) (2), (3), or (4) and §§ 29.23 (m)-3, 29.23 (m)-4, or 29.23 (m)-5.

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

§ 29.23 (m)-12 *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.* (a) Except as provided

in § 29.23 (m)-13, there shall be attached to the return of every taxpayer asserting a value for any mineral property as of specific date or claiming a deduction for depletion or depreciation a statement setting forth with respect to each mineral property (including oil and gas property):

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

(2) The nature of the taxpayer's interest in the property, accompanied by a certified copy of the instrument or instruments by which it was acquired;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(5) A property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the map should show depth, initial production, and date

of completion of each well, to the extent that such data are available);

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

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

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

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

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

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

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

§ 29.23 (m)-13 *Statement to be attached to return when depletion is claimed on percentage basis.* (a) There shall be attached to the return of every taxpayer who claims depletion of oil and gas wells under section 114 (b) (3) and § 29.23 (m)-4, or depletion of coal mines, metal mines, bauxite mines, fluorspar mines, flake graphite mines, vermiculite mines, beryl mines, feldspar mines, mica mines, talc (including pyrophyllite) mines, lepidolite mines, spodumene mines, barite mines, ball, sagger, and china clay mines, phosphate rock mines, rock asphalt mines, and trona, bentonite, gilsonite, thenardite, and sulphur and potash mines or deposits including potash salts in solution under section 114 (b) (4) (A) and § 29.23 (m)-5, a statement containing the following information with respect to every property for which percentage depletion is allowable:

(1) All data necessary for the determination of the "gross income from the property" as defined in § 29.23 (m)-1 (f), including the amounts paid to lessors as rents or royalties, the amounts paid to holders of other interests in the mineral property and the price per unit at which royalties were paid;

(2) All additional data necessary for the determination of the "net income of the taxpayer (computed without allowance for depletion) from the property" as defined in § 29.23 (m)-1 (g); and

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5645, 13 F. R. 4257]

§ 29.23 (m)-14 *Discovery of mines other than coal, metal, bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, ball, sagger, and china clay, rock asphalt, phosphate rock, trona, bentonite, gilsonite, thenardite, potash, and sulphur mines or deposits.* (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 the mines described in this paragraph) or minerals (other than the minerals described in this paragraph), it must appear that the mine or minerals

were not acquired as the result of the purchase of a proven tract or lease; also the discovery must be made by the taxpayer after February 28, 1913, and must result in the fair market value of the property becoming disproportionate to cost. For the purpose of this section, coal, metal, fluorspar, ball and sagger clay, rock asphalt, and sulphur mines shall not be entitled to valuation upon the basis of discovery with respect to any taxable year, flake graphite mines shall not be entitled to such valuation for taxable years beginning after December 31, 1942, vermiculite, beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene, and barite mines, and potash mines or deposits including potash salts in solution shall not be entitled to such valuation for taxable years beginning after December 31, 1943, and bauxite, pyrophyllite, china clay, phosphate rock mines, and trona, bentonite, gilsonite, and thenardite (from brines or mixtures of brine) mines or deposits shall not be entitled to such valuation for taxable years beginning after December 31, 1946; likewise the discovery in any taxable year of oil or gas, coal, sulphur, metal, metallic ores, fluorspar, ball and sagger clay, or rock asphalt shall not entitle the property to valuation based on discovery with respect to any taxable year, of flake graphite shall not entitle the property to such valuation with respect to any taxable year beginning after December 31, 1942, of vermiculite, beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene, barite, and potash shall not entitle the property to such valuation with respect to any taxable year beginning after December 31, 1943, and of bauxite, pyrophyllite, china clay, phosphate rock, trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine) shall not entitle the property to such valuation with respect to any taxable year beginning after December 31, 1946. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered minerals are of such quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploitation.

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

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

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

(e) The value of property claimed as the result of a discovery must be the fair market value, as defined in § 29.23 (m)-7, based on what is evident within 30 days after the commercially valuable character and extent of the discovered deposits of mineral have with reasonable certainty been established, determined, or proved.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5645, 13 F. R. 4257]

§ 29.23 (m)-15 *Allowable capital additions in case of mines.* (a) All expenditures in excess of net receipts from minerals sold shall be charged to capital account recoverable through depletion while the mine is in the development stage. The mine will be considered to

have passed from a development to a producing status when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining.

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

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

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

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

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

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

(2) Recovery of optional items, if capitalized:

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

(ii) Items returnable through depreciation: If in exercising these options,

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

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

(3) Nonoptional items distinguished:

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

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

(4) This paragraph does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)-16 of Regulations 86 or under article 23 (m)-16 of Regulations 94 (26 CFR, 1938 ed., 3.23 (m)-16) or under article 23 (m)-16 of Regulations 101 (4 F. R. 616) or under 26 CFR, 1940 Supp., 19.23 (m)-16 of Regulations 103 is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1942, or after December 31, 1941, in connection with oil and gas wells. Any taxpayer who has never made expenditures for drilling oil or gas wells prior to the first taxable year beginning after December 31, 1941, must make an election as to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures, and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1941, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (i) in his return for the first taxable year ending after December 31, 1924, in which optional expenditures of the respective type are or were made, or (ii) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4025. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1941, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

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

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

(i) Option with respect to intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties: All expenditures made by an operator for wages, fuel, repairs, hauling,

supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the operator, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or the gross proceeds from production, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (*a*) in the drilling, shooting, and cleaning of wells; (*b*) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (*c*) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

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

(2) Recovery of optional items, if capitalized:

(i) Items returnable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of well, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(ii) Items returnable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

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

(iv) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made

in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(3) Nonoptional items distinguished:

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

(ii) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by paragraph (b) of this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas.

(4) Paragraph (b) of this section grants a new option with respect to intangible drilling and development costs incurred by an operator in a taxable year beginning after December 31, 1942, in the development of oil and gas properties, and requires a new election under such option. Any operator who incurs such costs must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such costs are incurred. The absence of a clear indication in such return of an election to deduct as expenses intangible drilling and development costs shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property. This election is binding for all subsequent years.

§ 29.23 (m)-17 *Depreciation in case of mines.* (a) The Internal Revenue Code provides that deductions for depreciation of improvements on mining property may be taken "according to the peculiar conditions in each case." This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence. (See §§ 29.23 (l)-1 to 29.23 (l)-10, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

(b) It shall be optional with the taxpayer, subject to the approval of the Commissioner, whether the cost or other basis of the plant and equipment plus allowable capital additions but minus estimated salvage value shall be recovered (1) at a rate established by current exhaustion of mineral, or (2) by reasonable charges for depreciation (see § 29.23 (l)-1) at a rate determined by the physical life or the economic life of such plant and equipment, or, (3) according to the peculiar conditions of the case, by a method satisfactory to the Commissioner.

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

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

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

(f) Nothing in §§ 29.23 (m)-1 to 29.23 (m)-19 shall be interpreted as meaning (1) that the cost or other basis of a mining plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, or (2) that proper deductions for depreciation on account of obsolescence and decay shall not be made during periods when the mine is idle or is producing at a rate below its normal capacity. In estimating the salvage value of the equipment at the end of its estimated economic life due consideration may be given to its specialized character and the cost of dismounting and dismantling and transporting it to market.

(g) Nothing in §§ 29.23 (m)-1 to 29.23 (m)-19 shall be interpreted to permit expenditures charged to expense in any taxable year or any part of the value of land for purposes other than mining to be recovered through depletion or depreciation.

§ 29.23 (m)-18 *Depreciation of improvements in case of oil and gas wells.* Taxpayers operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under § 29.23 (m)-16. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See §§ 29.23 (l)-1 to 29.23 (l)-10, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

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

§ 29.23 (m)-20 *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 113 (a) adjusted as provided by section 113 (b). For capitalization of carrying charges, see § 29.113 (b) (1)-1. The apportionment of deductions between the several owners of economic interests in timber properties will be made as specified in § 29.23 (m)-7. The cost of timber properties shall be determined in accordance with the principles indicated in § 29.23 (m)-6. For method of determining fair market value and quantity of timber, see §§ 29.23 (m)-25 to 29.23 (m)-27. For depletion purposes the cost of the timber shall not include any part of the cost of the land.

§ 29.23 (m)-21 *Computation of allowance for depletion of timber for given year.* (a) The allowance for depletion

of timber in any taxable year shall be based upon the number of units of timber felled during the year and the depletion unit of the timber in the timber account or accounts pertaining to the timber cut. The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (1) the basis, provided by section 113 (a) and adjusted as provided by section 113 (b), of the timber on hand at the beginning of the year plus the cost of the number of units acquired during the year plus proper additions to capital, by (2) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of the number of units of timber cut from the given account during the year multiplied by the depletion unit of the timber for the given account for the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts, see §§ 29.23 (m)-27 and 29.23 (m)-28.

(b) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 117 (k) (1) the allowable depletion shall be the fair market value of the timber cut during the taxable year. Such fair market value shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5413, 9 F. R. 13104]

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

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

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

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

(b) In no case may charges for depreciation be based on a rate which will extinguish the cost or other basis of the property prior to the termination of its useful life. Nothing in §§ 29.23 (m)-20 to 29.23 (m)-28 shall be interpreted to mean that the value of a timber plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation. (See §§ 29.23 (l)-1 to 29.23 (l)-10, as to deductions for depreciation and obsolescence generally. See particularly § 29.23 (l)-5 with regard to infor-

mation which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)

§ 29.23 (m)-24 *Information to be furnished by taxpayer claiming depletion of timber.* (a) 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:

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

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

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

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

(5) Record of timber cut;

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

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

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

(9) Unit production costs; and

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

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

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

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

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

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

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

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

(c) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any timber property must be ascertained as of any specific date for the determination of the basis for depletion,

the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the timber property in fee simple.

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

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

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

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

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

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

§ 29.23 (m)-28 *Timber depletion and depreciation accounts on books.* (a) Every taxpayer claiming or expecting to claim a deduction for depletion or de-

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preciation of timber property (including plants, improvements, and equipment used in connection therewith) shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the property, and the plants, improvements, and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments provided by section 113 (b) and §§ 29.113 (a) (14)-1 and 29.113 (b) (1)-1 to 29.113 (b) (3)-2.

(b) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost of value shall be allocated to each. (See § 29.23 (m)-27.) These accounts shall be credited with the amount of the depreciation and depletion deductions computed in accordance with § 29.23 (m)-20 each year, or the amount of the depreciation and depletion shall be credited to depreciation and depletion reserve accounts, to the end that when the sum of the credits for depreciation and depletion equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deduction for depreciation and depletion will be allowed.

§ 29.23 (o)-1 *Contributions or gifts by individuals.* (a) A deduction is allowable under section 23 (o) only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A deduction is not allowable, however, for the actual payment of a contribution or gift if the amount of such payment already has been deducted on the accrual basis in computing net income for any taxable year beginning before January 1, 1938. A contribution or gift to an organization described in section 23 (o) is deductible even though some portion of the funds of such organization is or may be used in foreign countries for charitable and educational purposes. This section does not apply to contributions or gifts by estates and trusts (see section 162). For computation of deductions for charitable contributions where the taxpayer also has an allowable deduction for medical expenses, see § 29.23 (x)-1.

(b) A contribution or gift to the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any possession of the United States, exclusively for public purposes, is deductible.

(c) No deduction is allowed in computing the net income of a common trust fund or a partnership for contributions or gifts made to organizations described in section 23 (o). (See sections 169 and 183.) However, a partner's proportionate share of contributions or gifts actually paid by a partnership during its taxable year to such organizations may be allowed as a deduction in his individual personal return for his taxable year with or within which the taxable year of the partnership ends, to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 percent of his adjusted gross income or, for taxable years beginning prior to January 1, 1944, 15 percent of his net income computed without the benefit of the deduction for contributions. In the case of a nonresident alien individual or a citizen of the United States entitled to the benefits of section 251, see sections 213 (c) and 251. For contributions or gifts by corporations, see § 29.23 (q)-1.

(d) In the case of husband and wife making a joint return, the deduction for contributions or gifts is the aggregate of such contributions or gifts made by the spouses, and is limited to 15 percent of the aggregate adjusted gross income of the spouses or, for taxable years beginning prior to January 1, 1944, 15 percent of the aggregate net income of the spouses computed without the benefit of the deduction for contributions.

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

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

(g) If the contribution or gift is other than money, the basis for calculation of the amount thereof shall be the fair mar-

ket value of the property at the time of the contribution or gift.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 12]

§ 29.23 (p)-1 *Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; in general.* (a) Section 23 (p) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 23 (p) does not apply to a plan which does not defer the receipt of compensation. Neither does section 23 (p) apply to deductions for contributions under a plan which is primarily a dismissal wage, or unemployment benefit plan or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, or a combination thereof. Section 23 (p) is, however, applicable to all contributions (including contributions to provide incidental benefits such as life insurance protection) under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employees' rights in such contributions are nonforfeitable, but deductions under this section are subject to conditions and limitations under section 23 (a) as well as those particularly provided in section 23 (p).

(b) In order to be deductible under section 23 (p), contributions must be expenses which would be deductible under section 23 (a) if it were not for the provision in section 23 (p) (1) that they are deductible, if at all, only under section 23 (p). Contributions may therefore be deducted under section 23 (p) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on trade or business and are compensation for personal services actually rendered. In no case is a deduction allowable under section 23 (p) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 115 (a). See also §§ 29.23 (a)-6 and 29.23 (a)-8. In addition to the limitations referred to above, deductions under section 23 (p) are also subject to further conditions and limitations particularly provided therein.

(c) Section 23 (p) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to such of its retired employees and in such amounts as may be determined from time to time by the

board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 23 (p). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

(d) Deductions under section 23 (p) are generally allowable only for the year for which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his return on the accrual basis. Exceptions are made in the case of overpayments as provided in subparagraphs (A), (C), and (F) of section 23 (p) (1), and, as provided by section 23 (p) (1) (E), in the case of payments made by a taxpayer on the accrual basis within 60 days after the close of the taxable year of accrual. This latter provision is intended to permit a taxpayer on the accrual basis to deduct such accrued contribution or compensation, provided payment is actually made within 60 days after the close of the year of accrual.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5666, 13 F. R. 6557]

§ 29.23 (p)-2 *Information to be furnished by employer claiming deductions.* If a deduction from gross income is claimed under section 23 (p) (1) (A), (B), (C), or (F), the employer, except as otherwise provided in paragraph (j) of this section, must file the following information for each plan involved to establish that it meets the requirements of section 165 (a) or 23 (p) (1) (B), and that the deductions claimed do not exceed the amount allowable under subparagraphs (A), (B), (C), or (F) of section 23 (p) (1), as the case may be:

(a) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(b) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable, and a summary of the provisions and rules relating to:

(1) Employee eligibility requirements for participation in the plan,

(2) Employee contributions,

(3) Employer contributions,

(4) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(5) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly in-

sured, the medium of contributions and the kind of investments, and

(6) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(c) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their non-deferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(1) Name.

(2) Whether an officer.

(3) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(4) Whether the principal duties consist in supervising the work of other employees.

(5) Year of birth.

(6) Length of service for employer to the close of the year.

(7) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components: (i) Basic compensation and overtime pay, (ii) other direct payments, such as bonuses and commissions, (iii) compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(8) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(9) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components: (i) Amounts originally allocated in the year, and (ii) amounts reallocated in the year.

(10) Amount of employee contributions during the year under the plan.

(11) If a pension or annuity plan, (i) the retirement age and date and the form of the retirement benefit, (ii) the annual rate or amount of the retirement benefit, and (iii) the aggregate of all of the employee's contributions under the plan, all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(d) The following totals:

(1) Total non-deferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(2) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employees contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components: (i) Amount originally allocated in the year, and (ii) amount reallocated in the year.

(e) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(1) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(2) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subparagraph (1) of this paragraph.

(3) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subparagraphs (1) or (2) of this paragraph.

(4) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(5) All employees ineligible for coverage under the plan other than those employees included in subparagraphs (1),

(2), (3), or (4) of this paragraph, specifying the reasons applicable to the group.

(6) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subparagraphs (1) to (5), of this paragraph.

(7) All employees eligible for coverage but not covered under the plan.

(8) All employees covered under the plan.

(9) All employees of the employer, which should be the sum of subparagraphs (6), (7), and (8) of this paragraph.

If it is claimed that the requirements of section 165 (a) (3) (A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(f) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(g) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held. Also a summary of the resulting costs or liabilities and adjustments for the year under the pension or annuity plan in sufficient detail to permit ready verification of the reasonableness thereof.

(h) A statement of the applicable limitations under section 23 (p) (1) (A), (B), (C), or (F) and an explanation of the method of determining such limitations and a summary of the data and computations necessary to determine the allowable deductions for the taxable year.

(i) A statement of the contributions paid in the taxable year, showing the date and amount of each payment. Also a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components: (1) Under section 23 (p) (1) for contributions paid in the taxable year before giving effect to the provisions of subparagraph (F) thereof, (2) under section 23 (p) (1) for contributions paid in prior taxable years beginning after December 31, 1941 in accordance with the carry-over provisions of subparagraphs (A) and (C) thereof before giving effect to the provisions of subparagraph (F) thereof, (3) any reductions or increases in the deductions in accordance with the provisions of subparagraph (F) thereof, and (4) under section 23 (p) (2) for contributions paid to a pension trust in a taxable year beginning before January 1, 1942.

(j) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a), (b), or (g) of this section are based, a detailed statement explaining the change and its effect must be filed with the information otherwise required for the taxable year in which the change is put into effect and, insofar as there is no such change, after the data and information specified in those paragraphs has been filed in connection with a tax return, unless otherwise requested by the Commissioner, a statement that there is no such change may be filed in lieu of repeated filing of the information. After the information specified in paragraph (c) of this section has been filed for two consecutive years, unless otherwise requested by the Commissioner, so long as the plan and the method and basis of allocations are not changed, the tabulation need show such information only with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(k) If a deduction is claimed under section 23 (p) (1) (D) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other subparagraphs of section 23 (p) (1), that the amount paid is an ordinary and necessary expense, and that the em-

ployees' rights to or derived from such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid.

(l) For the purpose of the above information, contributions paid in a taxable year should include those deemed to be so paid in accordance with the provisions of section 23 (p) (1) (E) and exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section "taxable year" refers to the taxable year of the employer and, unless otherwise requested by the Commissioner, a "year" which is not specified as a "taxable year" may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year beginning in the taxable year of the employer provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed except that, unless sooner requested by the Commissioner, such information, other than that specified in subparagraph (1) of paragraph (d) of this section and in paragraph (i), of this section may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(m) In any case all the information and data required by this section must be filed in the collector's office in which the employer files his tax returns and identified for association with the appropriate returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 165 (a). The Commissioner may, in addition, require any further information that he considers necessary to determine allowable deductions under section 23 (p) or qualification under section 165 (a) and may waive the filing of such information required herein which he finds unnecessary in a particular case. Unless requested by the Commissioner, the information specified above need not be filed for any taxable year ending prior to January 1, 1949, if the information specified in 26 CFR, 1943 Cum. Supp., 29.23 (p)–2 is filed for such year.

(n) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

[T. D. 5666, 13 F. R. 6558]

§ 29.23 (p)–3 *Amounts deductible under a plan in effect on or before September 1, 1942, for a taxable year beginning in 1942.* (a) Section 162 (d) of the Revenue Act of 1942 provides alternative limitations for a taxable year of an employer beginning in 1942 if the deductions are taken under a plan in effect on or before September 1, 1942. For the taxable year mentioned such plan need not meet the requirements of section 165 (a) (3), (4), (5), and (6) of the Internal Revenue Code. See § 29.165–5. If the plan meets the other requirements of section 165 (a) at all times during the taxable year, the employer will be entitled to the amount deductible under section 23 (p), as amended by the Revenue Act of 1942, for such taxable year, or for the amount determined under the following computation, whichever is the greater: The amount paid in such taxable year prior to September 1, 1942, to the extent that such amount is deductible under section 23 (a) and section 23 (p), prior to its amendment by the Revenue Act of 1942, plus such portion of the amount paid on or after September 1, 1942, and deductible under section 23 (p) (1), as amended by the Revenue Act of 1942, which the number of months after August 31, 1942, in the taxable year bears to 12. For example, an employer making a return on the calendar year basis paid into a pension trust on March 1, 1942, the sum of $200,000, and on October 1, 1942, he made a further contribution of $100,000. Assume that the total contributions of $300,000 would have been deductible under section 23 (a) and section 23 (p), prior to its amendment by the Revenue Act of 1942, but that only $240,000 thereof is deductible under section 23 (p), as amended by the Revenue Act of 1942, without giving effect to section 162 (d) (1) (C) of the Revenue Act of 1942. A deduction of $280,000 will be allowable for 1942, determined as follows:

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

(b) If contributions are paid to or under more than one plan in the taxable year beginning in 1942 and prior to September 1, 1942, the alternative limitations provided in section 162 (d) (1) (C) of the Revenue Act of 1942 are determined by applying the provisions of this section severally to the several plans and respective contributions. See also § 29.33 (p)-12.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5666, 13 F. R. 6559]

§ 29.23 (p)-4 *Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 165 (a); application of section 23 (p) (1) (A); in general.* (a) If contributions are paid by an employer in a taxable year beginning after December 31, 1941 to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 29.23 (p)-1), the contributions are deductible under section 23 (p) (1) (A) or (B) if the further conditions provided therein are also satisfied. As used here, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. For the meaning of "pension plan" as used here, see § 29.165-1 (a). Where disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 23 (p) (1) (A) or (B). See § 29.165-6 as to taxability to employees of cost of incidental insurance protection. In order to be deductible under section 23 (p) (1) (A), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 165 (a). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 23 (p) (1) (A) (iv), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 165 (a). See § 29.23 (p)-9 as to conditions for deductions under section 23 (p) (1) (B) in the case of an annuity plan. In either case the deductions are also subject to further limitations provided in section 23 (p) (1) (A). The limitations provided in section 23 (p) (1) (A), with an exception provided for certain years under clause (i) thereof (see §29.23 (p)-5), are based on the actuarial costs of the plan and section 23 (p) (1) (A) requires that the costs and the limitations based on costs under that section shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary (or, in certain cases under section 23 (p) (1) (A) (i), in accordance with a finding of the Commissioner).

(b) In determining costs for the purpose of limitations under section 23 (p) (1) (A), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 23 (p) (1) (A) exceed costs based on assumptions and methods all of which are reasonable in view of the provisions and coverage of the plan, funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement, whether or not discounted, which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years, and, unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost

arising from experience in the next preceding taxable year more favorable than the assumed experience on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under it are deductible under section 23 (a) to the extent that they are ordinary and necessary.

(d) In case contributions are paid in the employer's taxable year beginning in 1942 and prior to September 1, 1942, the limitation on deductions for such taxable year is subject to an exception provided in section 162 (d) (1) (C) of the Revenue Act of 1942 (see § 29.23 (p)-3).

(e) In case deductions are allowable under section 23 (p) (1) (C) as well as under section 23 (p) (1) (A) or (B), the limitations under section 23 (p) (1) (A) and (C) are determined and applied without giving effect to the provisions of section 23 (p) (1) (F) but the amounts allowable as deductions are subject to the further limitations provided in section 23 (p) (1) (F) (see § 29.23 (p)-12). [T. D. 5666, 13 F. R. 6559]

§ 29.23 (p)-5 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (i).* (a) Subject to the applicable general conditions and limitations (see § 29.23 (p)-4), the initial limitation under section 23 (p) (1) (A) (i) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5 percent limitation applies to the first taxable year beginning after December 31, 1941 for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year for which the 5 percent figure is not reduced by the Commissioner as provided below. For years to which the initial 5 percent limitation applies no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5 percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5 percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return a certification by a qualified actuary or by the company underwriting a nontrusteed annuity plan of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year, all determined by methods, factors, and assumptions appropriate as a basis of limitations under clause (iii). Whenever requested by the Commissioner a similar certification and statement shall be submitted for the year or years specified in such request. The Commissioner will make periodical examinations of such data at not less than 5-year intervals and will reduce the limitation under clause (i) below the 5 percent limitation for the years with respect to which he finds that the 5 percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the Commissioner with a request for a change in the limitation.

(c) For the purpose of limitations under clause (i), "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 165 (a), including a plan that qualifies under section 23 (p) (1) (B). Where two or more pension or annuity plans cover the same employee, under clause (i) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5

percent limitation applies, deductions under clause (i) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under clause (i) even where these are greater than the applicable limitations under clause (ii) or clause (iii).

[T. D. 5666, 13 F. R. 6560]

§ 29.23 (p)-6 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (ii).* (a) Subject to the applicable general conditions and limitations (see § 29.23 (p)-4), under section 23 (p) (1) (A) (ii) deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost is attributable, the remaining unfunded cost attributable to such individuals shall be distributed over a period of at least five taxable years.

(b) The determination of costs as a basis of deductions under clause (ii) of section 23 (p) (1) (A) may be illustrated by a case where it is estimated actuarially as of the beginning of the plan on the basis of appropriate assumptions and factors that employer contributions of 4 percent of compensation of each covered employee during his remaining service will be sufficient to provide the current service credits of all employees under the plan and employer contributions of 3 percent of compensation of each covered employee during his remaining service will be sufficient to provide the past service credits of all employees under the plan, so that the estimated cost for the first year is 7 percent of compensation of covered employees.

(c) The statutory limitation for any taxable year under clause (ii) is any excess of the amount necessary for the year on the basis of the costs over the amount allowable as a deduction under clause (i), all determined under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) For this purpose such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under clause (ii) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under clause (ii) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 29.23 (p)-4) and provided paragraph (e) of this section is not less than five times the annual rate of compensation in effect at the beginning of the year.

(e) Instead of determining the excess deductible under clause (ii) by the above method, such excess may be based upon costs determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until

the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan and the funding medium. In view of the relationship of clause (ii) to clauses (i) and (iii), however, if the excess is determined by a method other than that set forth in the preceding paragraph the total limitations under clauses (i) and (ii) combined must be determined by a method approved by the Commissioner, except where they do not exceed the limitations under clause (iii), adjusted for prior favorable experience.

[T. D. 5666, 13 F. R. 6560]

§ 29.23 (p)-7 *Pension and annuity plans; limitations under section 23 (p) (1) (A) (iii)*. (a) Subject to the applicable general conditions and limitations (see § 29.23 (p)-4), under section 23 (p) (1) (A) (iii), in lieu of amounts deductible under the limitations of clause (i) and clause (ii), deductions may be allowed to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(b) The limitation under clause (iii) for any taxable year is the sum or normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan, all determined under regulations prescribed by the Commissioner with the approval of the Secretary. For this purpose the normal costs may be determined by any generally accepted actuarial method and may be expressed either as (1) the aggregate of level amounts with respect to each employee covered under the plan, (2) a level percentage of payroll with respect to each employee covered under the plan, or (3) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but is subject to adjustments for prior favorable experience. See § 29.23 (p)-4. In any case past service or supplementary costs shall not be included in the limitation for any year when the amount required to fully fund or purchase such past service or supplementary credits has been deducted and no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

[T. D. 5666, 13 F. R. 6561]

§ 29.23 (p)-8 *Pension and annuity plans; contributions in excess of limitations under section 23 (p) (1) (A); application of section 23 (p) (1) (A) (iv)*. Where contributions paid by an employer in a taxable year beginning after December 31, 1941 to or under a pension or annuity plan exceed the limitations applicable to such year under section 23 (p) (1) (A) but otherwise satisfy the conditions for deduction under section 23 (p) (1) (A) or (B), in accordance with clause (iv) of section 23 (p) (1) (A) the excess contributions are carried over and deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeding year and the limitation applicable to such year under clause (i), (ii), or (iii). Such excess contributions are deductible under clause (iv) of section 23 (p) (1) (A) in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the limitation applicable to such year under clause (i), (ii), or (iii). The provisions of clause (iv) are to be applied after giving effect to the exception provided in section 162 (d) (1) (C) of the Revenue Act of 1942 for a taxable year beginning in 1942 (see

§ 29.23 (p)-3) but before giving effect to the provisions of section 23 (p) (1) (F) for any year. The carry-over provisions of section 23 (p) (1) (A) (iv), after effect has been given to section 162 (d) (1) (C) of the Revenue Act of 1942, but before effect has been given to section 23 (p) (1) (F) may be illustrated by the following example:

Taxable year ending December 31, 1942:	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000
Taxable year ending December 31, 1943:	
Amount of contributions paid in year	25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000
Taxable year ending December 31, 1944:	
Amount of contributions paid in year	10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

[T. D. 5666, 13 F. R. 6561]

§ 29.23 (p)-9 *Contributions of an employer under an employees' annuity plan that meets the requirements of section 165 (a); application of section 23 (p) (1) (B).* If contributions are paid by an employer in a taxable year beginning after December 31, 1941 under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 29.23 (p)-1), the contributions are deductible under section 23 (p) (1) (B) if the further conditions provided therein are satisfied. For the meaning of "annuity plan" as used here, see § 29.23 (p)-4. In order that contributions by the employer may be deducted under section 23 (p) (1) (B) all of the following conditions must be satisfied:

(a) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries. See § 29.165-1 (a).

(b) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in paragraphs (3), (4), (5), and (6) of section 165 (a). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 23 (p) (1) (A) (iv), the succeeding year also must end with or within a taxable year of the plan for which it meets such requirements. See §§ 29.165-3 and 29.-165-4. In the case of an annuity plan in effect on or before September 1, 1942, the requirements of these paragraphs do not apply to any period of the plan within the taxable year of the employer beginning in 1942 and are considered to be satisfied for the period beginning with the beginning of the first taxable year of the employer following December 31, 1942, and ending June 30, 1945, if the provisions thereof satisfy such requirements by June 30, 1945, and if by that time all provisions of such plan which are necessary to satisfy such requirements are in effect and have been made effective for all purposes with respect to the portion of such period after December 31, 1943. In the case of an annuity plan put into effect after September 1, 1942, and prior to January 1, 1945, these requirements are considered to be satisfied for the period beginning with the date on which it was put into effect and ending with June 30, 1945, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the portion of such period after December 31, 1943. In the case of an annuity plan put into effect after December 31, 1944, these requirements are considered to be satisfied for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if

all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 162 (d) of the Revenue Act of 1942, as amended by Public Law 511 (78th Congress), approved December 20, 1944, and § 29.165-5.

(c) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under the plan. For the purpose of this condition, "refunds of premiums" means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where (1) all credits are applied regularly as they are determined toward the premiums next due under the contracts before any further employer contributions are so applied, and (2) under the arrangement (i) no refund of premiums may be made during continuance of the plan unless applied as aforesaid and (ii) if refunds of premiums may be made after discontinuance of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service prior to its discontinuance have been purchased, such refunds will be applied in the taxable year of the employer in which received or in the next succeeding taxable year to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 165 (a) (4).

(d) Where the above conditions are satisfied, the amounts of deductions are under section 23 (p) (1) (B) are governed by the limitations provided in section 23 (p) (1) (A). See §§ 29.23 (p)-4 to 29.23 (p)-8.

[T. D. 5666, 13 F. R. 6561]

§ 29.23 (p)-10 *Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 165 (a); application of section 23 (p) (1) (C).* (a) If contributions are paid by an employer in a taxable year beginning after December 31, 1941 to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 29.23 (p)-1), the contributions are deductible under section 23 (p) (1) (C) if the further conditions provided therein are also satisfied. In order to be deductible under section 23 (p) (1) (C) the contributions must be paid in a taxable year of the employer which ends with or winthin a taxable year of the trust for which it is exempt under section 165 (a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 23 (p) (1) (C), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 165 (a).

(b) The amount of deductions under section 23 (p) (1) (C) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. For this purpose "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 165 (a), including a plan that qualifies under section 23 (p) (1) (B). The limitations under section 23 (p) (1) (C) apply to the total amount deductible for contributions to the trust regardless of how the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 23 (p) (1) (C), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or ac-

crued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. So long as the contributions do not in any year exceed the primary limitation, this is the only limitation under section 23 (p) (1) (C) which has any effect.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years where contributions in some taxable year beginning after December 31, 1941 are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years beginning after December 31, 1941 over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 23 (p) (1) (C) for all prior years beginning after December 31, 1941, after giving effect to the provisions of section 162 (d) (1) (C) of the Revenue Act of 1942 in computing both items (i) and (ii).

(e) In any case where the contributions in a taxable year beginning after December 31, 1941 exceed the amount allowable as a deduction for the year under section 23 (p) (1) (C) after giving effect to section 162 (d) (1) (C) of the Revenue Act of 1942, the excess is deductible in succeeding taxable years, in order of time, in which the contributions are less than the primary limitations, so that the total deduction for any such succeeding year is equal to the primary limitation for such year but not more than the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 23 (p) (1) (C) for prior years beginning after December 31, 1941.

(f) In case contributions are paid in the employer's taxable year beginning in 1942 and prior to September 1, 1942, the limitation on deductions for such taxable year is subject to an exception provided in section 162 (d) (1) (C) of the Revenue Act of 1942 (see § 29.23 (p)-3).

(g) In case deductions are allowable under section 23 (p) (1) (A) or (B), as well as under section 23 (p) (1) (C), the limitations under section 23 (p) (1) (A) and (C) are determined and applied without giving effect to the provisions of section 23 (p) (1) (F) but the amounts allowable as deductions are subject to the further limitations provided in section 23 (p) (1) (F) (see § 29.23 (p)-12).

(h) The provisions of section 23 (p) (1) (C), after effect has been given to section 162 (d) (1) (C) of the Revenue Act of 1942 but without giving effect to section 23 (p) (1) (F), may be illustrated as follows:

[Illustration of provisions of section 23 (p) (1) (C) after effect has been given to section 162 (d) (1) (C) of the Revenue Act of 1942 but without giving effect to section 23 (p) (1) (F) (all figures represent thousands of dollars)]

	Taxable (calendar) years						
	1942	1943	1944	1945	1946	1947	1948
1. Amount of contributions:							
(a) In taxable year	65	10	15	100	70	40	30
(b) Carried over from prior taxable years[1]	0	8	0	0	4	5	3
2. Primary limitation applicable to year: 15% of covered compensation in year [1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							
(a) Twice primary limitation				96	90	84	
(b) (1) Aggregate primary limitations (see item 2)				210	255	297	
(2) Aggregate prior deductions (see item 4 (c))				90	186	255	
Excess of (1) over (2)				120	69	42	
Lesser of (a) or (b)				96	69	42	
4. Amount deductible for year on account of:							
(a) Contributions in year	57	10	15	96	69	40	30
(b) Contributions carried over	0	8	0	0	0	2	3
(c) Total	57	18	15	96	69	42	33
5. Excess contributions carried over to succeeding years	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

[T. D. 5666, 13 F. R. 6562]

§ 29.23 (p)–11 *Contributions of an employer under a plan that does not meet the requirements of section 165 (a) (section 23 (p) (1) (D))*. Subparagraph (D) of section 23 (p) (1) covers all cases for which deductions are allowable under section 23 (p) (1) but not allowable under subparagraphs (A), (B), (C), or (F) of such section. No deductions is allowable under section 23 (p) (1) (D) for any contribution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except for the year when paid, and then only to the extent allowable under section 23 (p) (1). See § 29.23 (p)–1. If payments are made under such a plan and the amounts are not deductible under the other subparagraphs of section 23 (p) (1), they are deductible under subparagraph (D) to the extent that individual employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. As to what constitutes nonforfeitable rights of an employee, see § 29.165–7. If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year but the rights of the employee therein are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5666, 13 F. R. 6563]

§ 29.23 (p)–12 *Contributions of an employer where deductions are allowable under section 23 (p) (1) (A) or (B) and also under section 23 (p) (1) (C); application of section 23 (p) (1) (F)*. Where deductions are allowable under section 23 (p) (1) (A) or (B) for any taxable year beginning after December 31, 1941 on account of contributions under a pension or annuity plan and deductions are also allowable under section 23 (p) (1) (C) for the same year, on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 23 (p) (1) (F) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 23 (p) (1) (A) or (B) is also a beneficiary under the trusts for which deductions are allowable under section 23 (p) (1) (C). The provisions of section 23 (p) (1) (F) apply only to deductions for overlapping trusts or plans, i. e., for all trusts or plans for which deductions are allowable under section 23 (p) (1) (A), (B), or (C) except (a) any trust or plan for which deductions are allowable under section 23 (p) (1) (A) or (B) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 23 (p) (1) (C), and (b) any trust for which deductions are allowable under section 23 (p) (1) (C) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 23 (p) (1) (A) or (B). The limitations under section 23 (p) (1) (F) for any taxable year are based on the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under the overlapping trusts or plans in the year. For this purpose "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualified under section 165 (a), including a plan that qualifies under section 23 (p) (1) (B). The employees who are beneficiaries under overlapping trusts or plans in a year include all the employees who, in the year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans.

Under section 23 (p) (1) (F), any excess of the total amount otherwise deductible under section 23 (p) (1) (A), (B), or (C) for a taxable year beginning after December 31, 1941 for overlapping trusts or plans in the year over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deductions for such trusts or plans for a succeeding taxable year is equal to the lesser of:

(a) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(b) The sum of (1) the smaller of (i) 25 percent of the compensation other-

wise paid or accrued during the taxable year to all the employees who are beneficaries under such trusts or plans in the year, or (ii) the total of the amounts otherwise deductible under section 23 (p) (1) (A), (B), or (C) for the year for such trusts or plans, and (2) any carry-over to the year from prior years under section 23 (p) (1) (F), i. e., any excess otherwise deductible under section 23 (p) (1) (A), (B), or (C) for a prior taxable year beginning after December 31, 1941 but not deducted for a prior taxable year because of the limitations under section 23 (p) (1) (F).

The limitations under section 23 (p) (1) (F) are determined and applied after all the limitations, deductions otherwise allowable, and carry-overs under section 23 (p) (1) (A), (B), and (C) have been determined and applied, and, in particular, after effect has been given to the carry-over provision in clause (iv) under section 23 (p) (1) (A) and in the second and third sentences of section 23 (p) (1) (C). Where the limitations under section 23 (p) (1) (F) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carry-over which is distinct from and additional to any excess contributions carried over and deductible in succeeding years under the provisions in clause (iv) of section 23 (p) (1) (A) or in the third sentence of section 23 (p) (1) (C). The application of the provisions of section 23 (p) (1) (F) and the treatment of carry-overs for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1943 and covering the same employees may be illustrated as follows:

[Illustration of application of provisions of section 23 (p) (1) (F) and of treatment of carry-overs for overlapping pension and profit-sharing trusts put into effect in 1943 and covering the same employees (all figures represent thousands of dollars)]

	Taxable (calendar) years			
	1943	1944	1945	1946
Before giving effect to section 23 (p) (1) (F)				
Pension trust contributions and limitations, deductions, and carry-overs under section 23 (p) (1) (A):				
1. Contributions paid in year	215	85	140	60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0
Profit-sharing trust contributions and limitations, deductions, and carry-overs under section 23 (p) (1) (C):				
7. Contributions paid in year	200	125	105	65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
Application of section 23 (p) (1) (F)—totals for pension and profit-sharing trust				
13. Amount deductible for year under section 23 (p) (1) (F):				
(a) 30% of compensation covered in year [2]	[3]	300	270	180
(b) (1) (i) 25% of compensation covered in year [2]	275	250	225	150
(ii) Total amount otherwise deductible for year: (5) plus (11)	375	240	235	145
(iii) Smaller of (i) or (ii)	275	240	225	145
(2) Carry-over from prior years under section 23 (p) (1) (F)	0	100	40	10
(3) Sum of (1) (iii) and (2)	275	340	265	155
(c) Amount deductible: Lesser of (a) or (b) (3)	275	300	265	155
14. Carry-over to succeeding years under section 23 (p) (1) (F): 13 (b) (2) plus 13 (b) (1) (ii) minus 13 (c)	100	40	10	0

[1] Includes carry-over of 20 from 1945.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30% limitation not applicable to first year of plan.

In case contributions are paid in the employer's taxable year beginning in 1942 and prior to September 1, 1942, and the deduction allowable for such year is increased by the effect of section 162 (d) (1) (C) of the Revenue Act of 1942 (see § 29.23 (p)-3), the deductions otherwise allowable for such year under section 23 (p) (1) (A), (B) or (C) are considered to be those allowable after giving effect to the provisions of section 162 (d) (1) (C) of the Revenue Act of 1942 severally for the several overlapping trusts or plans in such year and the limitation applicable to such year under section 23 (p) (1) (F) is not less than the sum of (a) the amounts paid in such taxable year prior to September 1, 1942 to or under the overlapping trusts or plans and deductible under section 23 (a) or 23 (p) prior to amendment by section 162 (d) of the Revenue Act of 1942, and (b) so much of the amounts paid in such taxable year on or after September 1, 1942, to or under such trusts or plans as does not exceed that proportion of 25 percent of the compensation otherwise paid or accrued during such taxable year to all employees who are beneficiaries under such trusts or plans in the year, which the number of months in such taxable year after August 31, 1942 bears to twelve.

[T. D. 5666, 13 F. R. 6563]

§ 29.23 (q)-1 *Contributions or gifts by corporation.* (a) A corporation may, subject to the limitations provided by section 23 (q), deduct from its gross income contributions or gifts to organizations described in section 23 (q), except in computing net income for taxable years beginning before January 1, 1944, contributions or gifts to organizations organized and operated exclusively for veterans' rehabilitation services, or posts or organizations of war veterans, or auxiliary units of, or trusts or foundations for, any such posts or organizations are not deductible unless such contributions qualify as deductions under section 23 (q) prior to its amendment by section 114 of the Revenue Act of 1943. (See § 29.22 (b) (4)-1 for definition of "political subdivision.") Where payment is made in a taxable year beginning before January 1, 1949, the charitable deduction prescribed is allowable to corporations even though the gifts or contributions are used outside of the United States or its possessions. Such deduction shall, to the extent provided by that section, be allowed only for the taxable year in which such contributions or gifts are actually paid, regardless of when pledged and regardless of the method of accounting employed by the corporation in keeping its books and records. As to charitable contributions by corporations not deductible under section 23 (a), see § 29.23 (a)-13. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses are not deductible from gross income.

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5371, 9 F. R. 5111, T. D. 5645, 13 F. R. 4257]

§ 29.23 (u)-1 *Periodic alimony payments.* (a) A deduction is allowable under section 23 (u) with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 22 (k). As to the amounts required to be included in the income of the wife or former wife, as the case may be, see § 29.22 (k)-1. (For definition of husband and wife in such cases, see section 3797 (a) (17).)

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

(c) The deduction under section 23 (u) is allowed only to the obligor spouse. It is not allowed to an estate, trust, cor-

poration, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 22 (k) in the income of the wife or former wife, as the case may be, which payment is attributable to property transferred in discharge of his obligation and which, under section 22 (k) or section 171 is stated not to be includible in his gross income.

(d) The following examples illustrate cases in which a deduction is or is not allowed under section 23 (u):

Example (1). Pursuant to the terms of a decree of divorce, H, in 1940, transfers securities valued at $100,000 in trust for the benefit of W, which fully discharges all his obligations to W. For 1942 and thereafter the periodic payments made by the trust to W are required to be included in W's income under section 22 (k). Such payments are stated in section 22 (k) not to be includible in H's income and, therefore, under section 23 (u) are not deductible from his income.

Example (2). A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W $5,000 a year for her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1942 the trustees paid to W $4,000 from the income of the trust and $1,000 from the corpus of the trust. Under the provisions of section 22 (k) and 171 (b), W will include $5,000 in her income for 1942. (The trustees will deduct $4,000 from the income of the trust under section 162.) H will not include any part of the $5,000 in his income nor take a deduction therefor. If H had paid the $1,000 to W, rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction for $1,000 under the provisions of section 23 (u).

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

§ 29.23 (x)-1 *Medical, dental, etc., expenses.* (a) Section 23 (x) permits a deduction from gross income of payments for certain medical expenses. The deduction is allowable only to individuals and only with respect to medical expenses actualy paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If the medical expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December, 1942, but not paid until January, 1943, no deductions can be taken for the year 1942.

(b) The expenses paid must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer (see § 29.25-6 for description of dependents), not compensated for by insurance or otherwise. Where reimbursement, from insurance or otherwise, for medical expenses is not received until a taxable year subsequent to the year in which allowable medical expenses were paid, the reimbursement so received must be included in the gross income of the taxpayer for the taxable year received to the extent attributable to (and not in excess of) deductions allowed under section 23 (x) for any prior taxable year (see section 22 (b) (5)). Where during the year for which the deduction is taken payments are made for medical care which are not compensated for during such year but for which compensation is received in a subsequent year or years, the entire amount of the compensation so received if equal to or less than the amount which was deducted, shall be considered as attributable to the deduction taken for such prior year. If the amount of the compensation received in the subsequent year or years is greater than the amount which was deducted for the prior year, such portion of the compensation received which is equal in amount to the deduction taken shall be considered as attributable to such deduction. If the deduction for the prior year would have been greater than $2,500 or $1,250 as the case may be, but for the limitations on such deduction provided by section 23 (x), then, for the purposes of the two preceding sentences, the amount of the compensation received in a subsequent year or years shall be reduced by an amount equal to the amount by which the deduction for the prior year would have been greater than $2,500 or $1,250, as the case may be, but for such limitations. If compensation is received in a subsequent year or years, the net deduction for medical expenses will thus be the same as if the compensation had been received in the year in which the payments for medical care were made.

(c) It is unnecessary for the purposes of this section that the spouse or dependent of the taxpayer for whom the medical expenses are paid be such at the time of payment, or at the time they were incurred. Thus, payments made in June,

1942, by A, for medical services rendered B, his wife, in 1941, may be deducted by A for 1942 even though prior to payment for that year B died or secured a divorce; and payments made in July, 1942, by C for medical services rendered D in 1941 may be deducted by C for 1942 even though C and D were not married until June, 1942.

(d) Only such medical expenses are deductible for taxable years beginning prior to January 1, 1944, as exceed 5 percent of the net income for the taxable year computed without the deduction for medical expenses. Where the taxpayer has allowable deductions in a taxable year beginning prior to January 1, 1944, for charitable contributions and medical expenses, the allowable deductions for charitable contributions should be computed first without regard to the deduction for medical expenses, and thereafter, the deduction for medical expenses for such taxable year should be computed (see § 29.23 (a)-1). The maximum deduction allowable for medical expenses paid in any one taxable year beginning prior to January 1, 1944, is $2,500 in the case of a head of a family, or husband and wife filing a joint return for such taxable year. In all other cases the maximum for such years is $1,250.

(e) For taxable years beginning after December 31, 1943, only such medical expenses are deductible as exceed 5 percent of the adjusted gross income for the taxable year. As to what constitutes adjusted gross income see section 22 (n). The maximum deduction allowable for medical expense paid in any one taxable year beginning after December 31, 1943, is $1,250 in the case of a taxpayer having only one exemption under section 25 (b) and $2,500 in the case of a taxpayer entitled to more than one exemption under section 25 (b). A deduction for medical expenses shall not be deemed to have been allowed for any taxable year for which the taxpayer claimed and was allowed the standard deduction under section 23 (aa).

(f) The term "medical care" as used in this section and in section 23 (x) includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance). Payments for hospitalization insurance, or for membership in an association furnishing cooperative or so-called free-choice medical service, or group hospitalization and clinical care are amounts which may be deducted. Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of X-rays or therapy treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore deductible. Amounts expended for illegal operations or treatments or illegally procured drugs are not deductible. Allowable deductions under section 23 (x) will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for expenses for hospital, nursing (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, for drugs and medical and dental supplies (including artificial teeth or limbs), and for ambulance hire and travel primarily for and essential to the rendition of the medical services or to the prevention or alleviation of a physical or mental defect or illness, are deductible.

(g) In connection with claims for deductions under section 23 (x), the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and the approximate date of the actual payment thereof in each case. If payment was in kind, then such fact shall be so reflected. Claims for deduction must be substantiated, when requested by the Commissioner, by a statement from the individual or entity to which payment for medical expenses was paid showing the nature of the service rendered, to or for whom rendered, the amount paid therefor, and the date of the actual payment thereof, and by such other information as the Commissioner may deem necessary.

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

Example (1). Taxpayer A, divorced from B in December 1941 and having one dependent child, had net income for 1942 of $3,000 before deduction of medical expenses. During 1942 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation in September 1941, on B, his wife at the time

of the operation. In 1942 he received a payment of $50 for health insurance covering B's illness during 1941.

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

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

Example (2). Assuming that A, in example (1), brings suit in 1943 and in that year receives $150 upon a hospital insurance policy covering the expenses incurred by B in 1941, the amount included in taxable income for 1943 is $100, computed as follows (see section 22 (b) (5)):

Compensation received in 1943	$150
Less: Deduction allowed for prior year 1942	100
Amount to be excluded from gross income for 1943	50
Taxable income for 1943	100

Example (3). Taxpayer C, who is entitled to two surtax exemptions under the provisions of section 25 (b), had an adjusted gross income of $35,000 for the calendar year 1944. During 1944 he paid $9,000 for medical care. C received no compensation for such medical expenses in 1944, but in 1945 he receives $5,000 upon an insurance policy covering the medical expenses which he incurred in 1944. C was allowed a deduction of $2,500 from his gross income for 1944. The amount which C must include in his gross income for 1945 is $250 and the amount to be excluded from gross income for 1945 is $4,750, computed as follows (see section 22 (b) (5)):

Payment for medical care in 1944 (not compensated for in 1944)		$9,000
Less: 5 percent of $35,000 (adjusted gross income)		1,750
Excess of uncompensated medical expenses in 1944 over 5 percent of adjusted gross income		7,250
Allowable deduction for 1944		2,500
Amount by which medical deduction for 1944 would have been greater than $2,500 but for the limitations provided by section 23 (x)		4,750
Compensation received in 1945	$5,000	
Less: Amount by which medical deduction for 1944 would have been greater than $2,500 but for the limitations provided by section 23 (x)	4,750	
Compensation received in 1945 reduced by amount by which medical deduction for 1944 would have been greater than $2,500 but for the limitations provided by section 23 (x)		$250
Amount attributed to medical deduction taken for 1944		250
Amount to be included in gross income for 1945		250
Amount to be excluded from gross income for 1945 ($5,000 less $250)		4,750

Example (4). Assuming that C, in example (3), receives $8,000 in 1945 as compensation for the medical expenses which he incurred in 1944, the amount which C must include in his gross income for 1945 is $2,500 and the amount to be excluded from gross income for 1945 is $5,500, computed as follows (see section 22 (b) (5)):

Compensation received in 1945	$8,000
Less: Amount by which medical deduction for 1944 would have been greater than $2,500 but for the limitations provided by section 23 (x)	4,750
Compensation received in 1945 reduced by amount by which medical deduction for 1944 would have been greater than $2,500 but for the limitations provided by section 23 (x)	3,250
Deduction allowable for 1944	2,500
Amount of compensation received in 1945 to be included in gross income for 1945 as attributable to deduction allowable for 1944	2,500
Amount to be excluded from gross income for 1945 ($8,000 less $2,500)	5,500

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5414, 9 F. R. 13106, T. D. 5425, 10 F. R. 12, T. D. 5517, 11 F. R. 6531]

§ 29.23 (y)-1 *Special deduction for blind individuals.* (a) For taxable years beginning after December 31, 1943, a special deduction from gross income of $500 is allowed under the provisions of section 23 (y) to all blind individuals who qualify as such at any time on July 1 of the taxable year or, if the taxable year does not include July 1, on the last day of such taxable year. The term "blind individual" is defined in section 23 (y) (2). The deduction is allowable only if the taxpayer himself is the blind individual and is not allowable, e. g., in respect of a dependent who is blind. In the case of a joint return, if both husband and wife are blind individuals, a deduction of $1,000 is allowable, but if only the husband or wife is a blind individual, only $500 may be deducted.

(b) An individual claiming the special deduction provided in section 23 (y) should, if not totally blind as of the

status determination date, that is, as of July 1 of the taxable year or, if the taxable year does not include July 1, as of the last day of such taxable year, attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the status determination date, in the opinion of such physician or optometrist, (1) such individual's central visual acuity did not exceed 20/200 in the better eye with correcting lenses or (2) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If he is totally blind as of the status determination date, that is, if he cannot distinguish light from darkness, he should attach to his return a statement setting forth such fact.

[T. D. 5371, 9 F. R. 5111, as amended by T. D. 5425, 10 F. R. 13, T. D. 5451, 10 F. R. 4195]

§ 29.23 (z)-1 *Amounts representing taxes and interest paid to cooperative apartment corporation.* (a) A tenant-stockholder may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative apartment corporation representing certain taxes or interest paid or incurred by such corporation. Such amounts are not allowable as a deduction unless they represent the tenant-stockholder's proportionate share of the real estate taxes on the apartment building and the land on which it is situated, allowable as deductions under section 23 (c), paid or incurred by the cooperative apartment corporation prior to the close of the taxable year of the tenant-stockholder, or of the interest paid or incurred by the corporation prior to such time on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of such apartment building or in the acquisition of the land on which the building is situated.

(b) The deduction allowable under section 23 (z) shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. In case a tenant-stockholder pays or incurs all or a part of his proportionate share of such taxes and interest to the corporation, the amount so paid or incurred representing taxes and interest is allowable as a deduction if the requirements of section 23 (z) are otherwise satisfied. As used in this section the tenant-stockholder's proportionate share is that proportion which the stock of the cooperative apartment corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including that held by the corporation. If a tenant-stockholder pays or incurs to the corporation an amount on account of such taxes and interest and other items, such as maintenance, overhead expenses, and curtailment of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 23 (z) for such part of amounts representing the taxes or interest described therein as is deductible by a tenant-stockholder under any other provision of the Internal Revenue Code.

(c) In order to qualify as a "cooperative apartment corporation" under section 23 (z), the corporation shall have only one class of stock outstanding. Each stockholder of the corporation shall be entitled to occupy for dwelling purposes an apartment in a building owned or leased by such corporation. The stockholder is not required to occupy the apartment. The right as against the corporation to occupy the apartment is sufficient. Such right shall be conferred on each stockholder solely by reason of his ownership of stock in the corporation, that is, the stock shall entitle the owner thereof either to occupy the apartment or to a lease of the apartment. The fact that the right to continue to occupy the apartment is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial. None of the stockholders of the corporation shall be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings or profits of the corporation. It is a prerequisite to the allowance of a deduction under section 23 (z) that at least 80 percent of the gross income of the corporation for the taxable year of the corporation in

which the taxes and interest are paid or incurred is derived from tenant-stockholders.

(d) The term "tenant-stockholder" means an individual who is a stockholder in a cooperative apartment corporation as defined in section 23 (z), and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the Commissioner as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment which such individual is entitled to occupy.

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

Example (1). The X Corporation is, and at all times since 1940 has been, a cooperative apartment corporation within the meaning of section 23 (z). In 1940 it purchased a site and constructed thereon a building with 10 apartments at a total cost of $200,000. The fair market value of the land and building was likewise $200,000 at the time of completion of the building. Each apartment is of equal value. Upon completion of the building, the X Corporation mortgaged the land and building for $100,000, and sold its total authorized capital stock, consisting of 1,000 shares of common stock, for $100,000. The stock was purchased by 10 individuals, who each paid $10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified terms of years. Each lease provides that the lessee shall pay his proportionate part of the corporation's expenses. In 1940 the original owner of 100 shares of the common stock of the X Corporation and of the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its net income on the accrual basis, while A computes his net income on the cash basis. In 1941 the X Corporation incurred expenses aggregating $13,800, namely, $4,000 for the real estate taxes on the land and building, $5,000 for the interest on the mortgage, $3,000 for the maintenance of the building, and $1,800 for other expenses. In 1942, A pays the X Corporation $1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1941 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $900 in computing his net income for 1942. The deduction is computed as follows:

Shares of stock of X Corporation owned by A		100
Shares of stock of X Corporation owned by 9 other tenant-stockholders		900
Total shares of stock of X Corporation outstanding		1,000
Proportion of outstanding stock of X Corporation owned by A		1/10
Expenses incurred by X Corporation:		
Real estate taxes	$4,000	
Interest	5,000	
Maintenance	3,000	
Other expense	1,800	
		$13,800
Amount paid by A representing his proportionate part of such expenses (1/10 of $13,800)		1,380
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		900
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)		1,380
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,380)		900
A's allowable deduction		900

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the land and building which is attributable to apartment No. 1, the requirement of section 23 (z) in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

Example (2). The facts are the same as in example (1) except that the building constructed by the X Corporation contained, in addition to the 10 apartments, business space on the ground floor, which the corporation rented at $2,400 for the calendar year 1941; the corporation deducted the $2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders; the amount paid by A to the corporation in 1942 is $1,140 instead of $1,380; and more than 80 percent of the gross income of the corporation for 1941 was derived from tenant-stockholders. A is entitled under section 23 (z) to a deduction of $743.48 in computing his net income for 1942. The deduction is computed as follows:

Expenses incurred by X Corporation	$13,800.00
Less rent from business space	2,400.00
Expenses to be prorated among tenant-stockholders	11,400.00
Amount paid by A representing his proportionate part of such expenses (1/10 of $11,400)	1,140.00

A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	$900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,140)	743.48
A's allowable deduction	743.48

Since the portion of A's payment allocable to real estate taxes and interest is only $743.48, that amount instead of $900 is allowable as a deduction in computing A's net income for 1942.

Example (3). The facts are the same as in example (2) except that the amount paid by A to the X Corporation in 1942 is $1,000 instead of $1,140. A is entitled under section 23 (z) to a deduction of $652.17 in computing his net income for 1942. The deduction is computed as follows:

Total amount paid by A	$1,000.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,000)	652.17
A's allowable deduction	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only $652.17, that amount instead of $900 is allowable as a deduction in computing A's net income for 1942.

§ 29.23 (aa)-1 *Standard deduction*—(a) *General*. For taxable years beginning after December 31, 1943, the taxpayer may elect to take, in addition to the deductions from gross income allowable in computing adjusted gross income, a standard deduction in lieu of all nonbusiness deductions (that is, deductions other than those allowable under section 22 (n)) and in lieu of certain credits allowable to the taxpayer had he not so elected. Such credits are the credit provided by sections 31 and 131 for income tax paid to foreign countries or possessions of the United States, the credit provided by section 32 for tax paid at the source under section 143 (a) by the obligor on tax-free covenant bonds with respect to interest on such bonds, and the credit provided by section 25 (a) (1) and (2) for normal tax purposes with respect to interest on United States obligations and interest on obligations of instrumentalities of the United States. The standard deduction is $500, in the case of taxpayers whose adjusted gross income is $5,000 or more, and, in the case of taxpayers whose adjusted gross income is less than $5,000, about 10 percent of the adjusted gross income upon which the tax is determined in the table provided in section 400. A taxpayer having adjusted gross income of less than $5,000, who does not elect to pay the tax imposed by Supplement T, may not take the standard deduction.

(1) The standard deduction is not allowable:

(i) In the case of a taxable year of less than 12 months where such taxable year arises because of a change in accounting period under section 47 (a);

(ii) In the case of a return for a fractional part of a year under section 146 (a) (1);

(iii) In the case of an estate or trust;

(iv) In the case of common trust funds;

(v) In the determination of the net income of a partnership;

(vi) In the case of nonresident alien individuals (including those who enter and leave the United States at frequent intervals); and

(vii) In the case of a citizen of the United States entitled to the benefits of section 251.

(2) An election to take the standard deduction is not precluded by reason of the fact that the return is made for a taxable year of less than 12 months on account of the death of the taxpayer.

(b) *Manner and effect of election to take the standard deduction*. The following rules are prescribed with respect to the manner of signifying an election by a taxpayer to take the standard deduction:

(1) A taxpayer whose adjusted gross income as shown by his return is $5,000 or more shall be allowed the standard deduction only if he signifies on his return his election to take such deduction. Such taxpayer shall so signify on his return by claiming thereon a deduction of $500 instead of itemizing the deductions allowable under section 23 other than those specified in section 22 (n). The election so signified shall be irrevocable for the taxable year for which such election is made. If in any case the adjusted gross income shown on the return

of the taxpayer is $5,000 or more, but the correct adjusted gross income is less than $5,000, then:

(i) If the taxpayer has elected on his return to take the standard deduction such election shall be deemed to be an irrevocable election by the taxpayer to pay the tax imposed by Supplement T; and

(ii) If the taxpayer has not so elected upon his return, it shall be deemed that the taxpayer has irrevocably elected not to pay the tax under Supplement T.

(2) If the adjusted gross income shown on the return is less than $5,000, the standard deduction is allowable only if the taxpayer elects in the manner provided in Supplement T to pay the tax imposed by such supplement. As to the manner and effect of election to pay the tax under Supplement T, see § 29.402-1. In any case, however, in which adjusted gross income shown on the return is less than $5,000 but the correct adjusted gross income is in fact $5,000 or more, then:

(i) If the taxpayer has elected to pay the tax imposed under Supplement T, it shall be deemed that he has elected to take the standard deduction; and

(ii) If the taxpayer has not elected on his return to pay the tax under Supplement T, it shall be deemed that he has made an election not to take the standard deduction.

(c) *Husband and wife.* (1) In the case of husband and wife living together, if the net income of one spouse is determined without regard to the standard deduction, the other spouse may not elect to take the standard deduction. If a joint return is filed and election made thereon to take the standard deduction, such deduction shall be determined by reference to the aggregate adjusted gross income of both spouses. If Form W-2 (Rev.) is filed as a combined return, the standard deduction is allowed through the application to the adjusted gross income shown on such return of the tax table in Supplement T. See § 29.51-2 limiting the use of Form W-2 (Rev.) as a combined return to cases in which the aggregate adjusted gross income of the spouses is less than $5,000.

(2) If each spouse files Form 1040 both must elect to take the standard deduction or both are denied the standard deduction. If one spouse files Form 1040 and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, hence, may not file Form W-2 (Rev.) as his or her return. Thus, if A and his wife B have adjusted gross incomes of $6,000 and $3,500, from wages subject to withholding, respectively, for the calendar year 1944, and A files Form 1040 and does not elect thereon to take the standard deduction, B may not file Form W-2 (Rev.) but must file Form 1040, taking thereon only her actual allowable deductions and not the standard deduction. In such case, however, if both elect to take the standard deduction, A must file Form 1040, but B may file Form W-2 (Rev.) or, in the alternative, she may file Form 1040 and compute the tax under Supplement T. Under either alternative effect is given to the standard deduction through the application of Supplement T.

(3) The restriction upon the right of a married person to elect the standard deduction in his separate return is applicable with respect to the taxable years of the husband and wife ending in the same calendar year, except that in the event of the death of one spouse the restriction is applicable with respect to the taxable year ended with death and the taxable year of the surviving spouse in which such death occurs. The restriction applies only in the case of a husband and wife living together and for such purpose the spouses are considered as living together unless they are permanently separated. The determination of whether an individual is married and living with his spouse shall be made as of the last day of such individual's taxable year unless his spouse dies during such taxable year, in which event the determination shall be made as of the date of death of such spouse.

Example (1). Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. On the return for the fiscal year ended June 30, 1945, A itemized and claimed his actual deductions. In October 1945 A and B were permanently separated. In her separate return for the calendar year 1945 B may elect the standard deduction since she is not married and living with her husband A on the last day of her taxable year.

Example (2). Assume the facts as stated in Example (1) except that, instead of the spouses separating, A died in October 1945. In such case since A and B were married and living together as of the date of death, B may not elect the standard deduction for

the calendar year 1945, if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

[T. D. 5425, 10 F. R. 13]

§ 29.24-1 *Personal and family expenses.* Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives clients, patients, or callers there in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is deductible. If the father is entitled to the services of his minor children, any allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. Amounts paid as damages for breach of promise to marry, attorneys' fees and other costs of suit to recover such damages, and attorneys' fees paid in a suit for separation are not deductible from gross income. Amounts paid as alimony or allowance for support upon divorce or separation are not deductible except as provided in section 23 (u). The cost of equipment of an Army officer to the extent only that it is especially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not. For deduction of extraordinary medical expenses (including amounts paid for accident or health insurance), see section 23 (x) and § 29.23 (x)-1.

§ 29.24-2 *Capital expenditures.* Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount exponded for architects' service is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See § 29.22 (a)-16.) An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Internal Revenue Code, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

[Regs. III, 8 F. R. 14882, as amended by T. D. 5513, 11 F. R. 5347]

§ 29.24-3 *Premiums on business insurance.* Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is not a beneficiary under such a policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. (See §§ 29.22 (a)-3 and 29.23 (a)-6 to 29.23 (a)-9.) In either case the proceeds of such policies paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of certain transferees as provided in § 29.22 (b)

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(2)-3 and in the case of a spouse to whom such proceeds are income under section 22 (k). (See generally section 22 (b) (1) and (2) and §§ 29.22 (b) (1)-1 and 29.22 (b) (2)-3.)

§ 29.24-4 *Amounts allocable to exempt income, other than interest*—(a) *Class of exempt income.* (1) As used in this section, the term "class of exempt income" means any class of income, including interest only to the extent that amounts otherwise allowable under section 23 (a) (2) are allocable thereto (whether or not any amount of income of that class or classes is received or accrued), wholly exempt from the taxes imposed by chapter 1. Included are any item or class of income, including interest only to the extent that amounts otherwise allowable under section 23 (a) (2) are allocable thereto, constitutionally exempt from the taxes imposed by chapter 1; any item or class, as above defined, excluded from gross income under any provision of section 22 or section 116; and any item or class of income, as above defined, exempt under the provisions of any other law from the taxes imposed by chapter 1. The term "taxable income" as used in this section means income which is required to be included in gross income; and the term "exempt income" means income which is not required to be included in gross income.

(2) The object of section 24 (a) (5) is to segregate the exempt income from the taxable income, in order that a double exemption may not be obtained through the reduction of taxable income by expenses and other items, incurred in the production of items of income wholly exempt from tax. Accordingly, just as exempt items of income are excluded from the computation of gross income under section 22, so section 24 (a) (5) excludes from the computation of deductions under section 23 all items referable to the production of exempt income, as defined in subparagraph (1) of this paragraph.

(b) *Determination of amounts allocable to a class of exempt income.* (1) No deduction may be allowed for the amount of any item or part thereof allocable to a class or classes of exempt income. For example, expenses paid or incurred for the production or collection of income which is wholly exempt from income taxes, such as interest or dividends of a type not includible in gross income, are not deductible expenses. Items, or parts of such sums, directly attributable to any class or classes of exempt income, shall be allocated thereto; and items, or parts of such items, directly attributable to any class or classes of taxable income, shall be allocated thereto.

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

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

§ 29.24-5 *Taxes and carrying charges chargeable to capital account and treated as capital items*—(a) *General.* In accordance with section 24 (a) (7), items enumerated in paragraph (b) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property, of the type described in this section, are chargeable to capital account at the election of the taxpayer notwithstanding that they are expressly deductible under section 23. No deduction is permitted for any items so treated.

(b) *Taxes and carrying charges.* The following subparagraphs (1) to (4) of this paragraph may upon the election of the taxpayer, in the manner provided in paragraph (c) of this section, be treated as chargeable to capital account (either as a component of original cost or other basis, for the purposes of section 113 (a), or as an adjustment to basis, for the purposes of section 113 (b) (1) (A)), notwithstanding that they are expressly deductible under section 23:

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

(2) In the case of real property, whether improved or unimproved and whether productive or unproductive, expenditures (otherwise deductible) paid or incurred in the development thereof or in the construction of an improvement or additional improvement thereon, up to the time the development or construction work has been completed, such as interest on a loan made or continued to furnish funds for this purpose (but not including theoretical interest of a taxpayer using his own funds), taxes of the owner of the property measured by compensation paid to his employees and taxes of such owner imposed on the purchase of materials for such work or on the storage, use, or other consumption in the State of materials for such work which are purchased for storage, use, or other consumption in that State, and other necessary expenditures paid or incurred in connection therewith up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of taxable income (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein);

(3) In the case of personal property, taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to his plant or in installing them therein, interest on a loan to purchase such property or to pay for transporting or installing the same, and taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property in the State which is purchased for storage, use, or other consumption in that State, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(4) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(5) If for any taxable year there are two or more items, such as social security taxes, use taxes, or any other type of items above described, relating to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if several items of the same type are incurred with respect to a single project the election to capitalize must, if exercised, be exercised as to all of items of that type.

(6) Once, however, such an election is made under subparagraph (2), (3), or (4), of this paragraph, to capitalize a given charge incurred with respect to a particular project, charges of the same type incurred with respect to the particular project in subsequent years, whether they be social security taxes, use taxes, sales taxes, or any other item enumerated in any of these paragraphs, must also be capitalized for the entire period to which the election so to treat items of that type is applicable. The term "project" for this purpose in the case of items included in subparagraph (2) of this paragraph means the particular development or construction work with respect to which the charge as to which the election was exercised was incurred, and in the case of items included in subparagraph (3) of this paragraph this term means the act of transporting, installing, or putting into use of the machinery or other fixed assets. An election under subparagraph (1) of this paragraph, however, may be exercised for a given year without regard to the manner in which the same type of item with respect to the same property was treated by the taxpayer for a prior year.

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

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

the erection of this building until its completion in 1944.

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

Example (4). X in 1942 began the erection of a building for himself, which would take three years to complete. X in 1942 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. X may elect to capitalize the social security taxes although he deducts the interest charges.

Example (5). A purchases machinery in 1943 for use in his factory. He pays social security taxes on the labor for transportation and installation, as well as interest on a loan to obtain funds to pay for the machinery and for installation costs. A may capitalize the social security taxes and the interest up to the date of installation or until the machinery is first put into use by him, whichever is later.

(7) The sole effect of section 24 (a) (7) is to permit such items to be properly charged to capital account notwithstanding that a deduction is expressly provided therefor in section 23. Any item not charged to capital account which is otherwise deductible under section 23 is still deductible. An item may not be charged to capital account under this section where such treatment would be disallowed whether or not a deduction were expressly provided therefor in section 23 (such, for example, as maintenance expenses and the cost of repairs and upkeep of a personal residence). This section does not have the effect of disallowing an item to be treated as a capital item which would otherwise be allowed to be so treated nor does it have the effect of making deductible an item which is not so under section 23 (such, for example, as salaries or other compensation paid or incurred for services rendered in the construction of property.)

(8) In the absence of provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Nor is the absence of a provision in this section to be construed as withdrawing or modifying the right now given to the taxpayer under some other provision of chapter 1 of the Code or of the regulations promulgated thereunder to elect to capitalize or to deduct a given item. (See § 29.23 (m)-16, making intangible drilling and development costs chargeable to capital or to expenses at the taxpayer's option and § 29.23 (c)-2, making certain Federal duties and excise taxes deductible unless the taxpayer has added them to the expenses of the business or the cost of the articles of merchandise.)

(c) *Manner of exercising election.* If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return a statement for that year indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account (either as a component of original cost or other basis, for the purposes of section 113 (a), or as an adjustment to basis, for the purposes of section 113 (b) (1) (A)).

(d) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no option to treat as a capital item or as an allowable deduction is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. Apportionment must in all cases be reasonable.

Example. A, the owner of a factory on which a new addition is under construction, in 1942 pays its general manager, B, a salary of $4,000 and social security taxes of $90 measured thereby. B spends nine tenths of his time in the general business of the firm and the remaining tenth in supervising the construction work. A treats as expenses $3,600 of B's salary and charges the remaining $400 to capital account. A may also capitalize $9 of the $90 social security taxes.

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

tween fiduciaries of trusts having a common grantor; (3) between a grantor and a fiduciary of the same trust; or (4) between a fiduciary of a trust and a beneficiary of such trust.

(b) *Corporations (including shareholders).* In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24 (b) (1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual shareholder (see section 24 (b) (1) (B) or between two corporations (see section 24 (b) (1) (C)). Under section 24 (b) (1) (B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. Under section 24 (b) (1) (C), however, as provided therein, not only must more than 50 percent in value of the outstanding stock of each of such corporations be owned, directly or indirectly, on the date of the sale or exchange by or for the same individual, but one of the corporations must be either a personal holding company as defined in section 501, or a foreign personal holding company as defined in section 331, for the taxable year preceding the date of the sale or exchange. It is not necessary that either of the corporations be a personal holding company or a foreign personal holding company on the date of the sale or exchange.

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

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

Example (1). On July 1, 1942, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1941 was a personal holding company under section 501. On that day all of the outstanding stock of the M Corporation was owned by A. By the application of the rule provided in section 24 (b) (2) (A), the stock in the O Corporation owned by the M Corporation is considered to be owned constructively by A, the sole stockholder of the M Corporation. Such constructive ownership of the stock of the O Corporation by A is considered as actual ownership for the purpose of applying the family rule provided in section 24 (b) (2) (B) to make a member of A's family, as, for example, his wife AW, the constructive owner of the stock of the O Corporation. But the constructive ownership of the O Corporation stock by AW may not be considered as actual ownership by AW for the purpose of again applying the family rule so as to make a member of AW's family, for example, her father, AWF, in turn constructive owner of such stock. These rules apply in the same manner and with the same effect in determining the ownership of stock in the M Corporation.

Accordingly, assuming that A, AW, AWF, the M Corporation and the O Corporation make their income returns on the basis of a calendar year and that there was no distribution in complete or partial liquidation of the M or O Corporation, no deduction is allowable under section 24 (b) (1) with respect to losses from sales or exchanges of property made on July 1, 1942, between any of such individuals or corporations, except as between A and AWF and between AWF and the M or O Corporation.

Example (2). On June 15, 1942, all of the stock of the N Corporation was owned in equal proportions by A and A's partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1942, between A and the N Corporation or AP and the N Corporation inasmuch as, by the application of section 24 (b) (2) (C), each partner is considered as having owned the stock owned by the other and, therefore, is considered as having owned more than 50 percent in value of the outstanding stock of the N Corporation. Deductions for losses from sales or exchanges between A's brother, AB, and the N Corporation, or between AP and A, or AP and AB are not prohibited by section 24 (b).

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

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

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

(b) No deductions shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, if the estate or trust is entitled to a deduction under chapter 1 but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss, but must include in his return the full amount distributed or distributable. (See section 162.) However, in the case of property held by one person for life with remainder to another person and in the case of property held in trust, see section 23 (l) as to depreciation and section 23 (m) as to depletion.

§ 29.24-9 *Single premium life insurance or endowment contracts.* Amounts paid or accrued on indebtedness incurred or continued, directly and indirectly, to purchase a single premium life insurance or endowment contract are not deductible under section 23 (b) or any other provision of chapter 1. This prohibition applies even though the insurance is not on the life of the taxpayer. A contract shall be considered a single premium life insurance or endowment contract, for the purposes of this section, if substantially all the premiums on such contracts are paid within a period of four years from the date on which the contract was purchased.

§ 29.25-1 *Credits of individuals against net income.*—(a) *Taxable years beginning before January 1, 1944.* For the purpose of computing the normal tax the taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is first reduced by the sum of the allowable credits. These include interest exempt from normal tax only (and hence included in gross income) received upon (1) certain obligations of the United States and (2) certain obligations of corporations organized under act of Congress which are instrumentalities of the United States; an earned income credit; a personal exemption; and a credit for dependents. (See section 22 (b) (4).) For the purpose of computing the surtax the taxpayer's net income is entitled to none of these credits, except the credit for personal exemption and credit for dependents.

(b) *Taxable years beginning after December 31, 1943 and before January 1, 1946.* For taxable years beginning after December 31, 1943, and before January 1, 1946, the taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is reduced, for the purpose of computing the normal tax, by (1) the income exempt from normal tax only received upon certain obligations of the United States and upon certain obligations of corporations organized under act of Congress which are instrumentalities of the United States, and (2) one normal-tax exemption of $500, or in the case of a joint return by husband and wife a normal-tax exemption of $1,000, but if one of the spouses has less than

$500 adjusted gross income the normal-tax exemption is $500 plus the amount of the adjusted gross income of such spouse. For such taxable years no exemption for dependents is allowed for normal tax purposes.

(c) *Taxable years beginning after December 31, 1945.* For taxable years beginning after December 31, 1945, the taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is reduced, for the purpose of computing the normal tax, by (1) the income exempt from normal tax only received upon certain obligations of the United States and upon certain obligations of corporations organized under act of Congress which are instrumentalities of the United States, and (2) the credits for both normal tax and surtax under section 25 (b). See § 29.25-3.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5373 9 F. R. 5501, T. D. 5425, 10 F. R. 14, T. D. 5517, 11 F. R. 6531]

§ 29.25-2 *Earned income credit for taxable years beginning before January 1, 1944.* (a) Under section 25 (a) (3) prior to its repeal by section 107 of the Revenue Act of 1943, the earned income credit allowable for taxable years beginning before January 1, 1944, for the purpose of computing the normal tax is 10 percent of the amount of the earned net income, but not in excess of 10 percent of the amount of the entire net income.

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

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

(d) The provisions of sections 25 (a) (3) and 25 (a) (4) prior to their repeal by section 107 of the Revenue Act of 1943, may be illustrated generally by the following examples:

Example (1). An individual received income from interest on bonds during the calendar year 1942 amounting to $6,000. His allowable deductions under section 23 for that year amounted to $2,000. He is entitled to an earned income credit of $300, computed as follows:

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

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

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

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

net income for the year. He is entitled to an earned income credit of $700, computed as follows:

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5373, 9 F. R. 5501]

§ 29.25-3 *Personal exemption, surtax exemptions, and exemptions for both normal tax and surtax*—(a) *Taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, a single person or a married person not living with a husband or wife is entitled to a personal exemption of $500, and the head of a family or a married person living with husband or wife is entitled to a personal exemption of $1,200. A husband and wife living together have but one personal exemption, which is $1,200. If they make separate returns, each may claim one-half of the personal exemption, or such exemption may, in accordance with an agreement entered into by them, be taken by either or divided between them in any proportion. With regard to returns by husband and wife under Supplement T, see section 404.

(b) *Taxable years beginning after December 31, 1943 and before January 1, 1946.* For the purpose of the surtax on individuals for taxable years beginning after December 31, 1943, and before January 1, 1946, there are allowed as credits against net income a surtax exemption of $500 for the taxpayer and, provided certain prescribed conditions are met, a surtax exemption of $500 for the spouse of the taxpayer and for each dependent of the taxpayer. Two surtax exemptions of $500 each are allowable in case a joint return is filed under section 51 by a husband and wife or in case a separate return is made by the taxpayer, and his spouse has no gross income for the calendar year in which the taxpayer's taxable year begins, and his spouse is not the dependent of another taxpayer. If in any case a joint return is made by the taxpayer and his spouse, no surtax exemption is allowed any other person for such spouse even though such other person would have been entitled to claim a surtax exemption for such spouse as a dependent if such joint return had not been made. In addition to the surtax exemptions allowed to a taxpayer for himself and for his spouse he is entitled to a surtax exemption of $500 for each individual whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $500, who receives more than one-half of his support from the taxpayer for such calendar year, who does not file a joint return with his spouse and who is related to the taxpayer within one of the following relationships: Child; the descendants of such child; stepchild; brother; sister; brother or sister by the half-blood; stepbrother or stepsister; parent; the ancestors of such parent; stepfather or stepmother; son or daughter of the taxpayer's brother or sister; brother or sister of the taxpayer's father or mother; son-in-law; daughter-in-law; father-in-law; mother-in-law; brother-in-law; or sister-in-law. In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. A legally adopted child of a person shall be considered a child of such person by blood. A citizen or subject of a foreign country may not be claimed as a dependent, unless he is a resident of the United States, Canada, or Mexico at some time during the calendar year in which the taxable year of the taxpayer begins. Whether or not over half of a person's support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer, shall be determined by reference to the amount of expense incurred by the taxpayer for such support. A payment to a wife which is includible under section 22 (k) or section 171 in the gross

income of such wife shall not be considered a payment by her husband for the support of any dependent.

(c) *Taxable years beginning after December 31, 1945.* For the purpose of the normal tax and surtax on individuals for taxable years beginning after December 31, 1945, there are allowed as credits against net income the exemptions specified in section 25 (b). Except that such exemptions are not designated "surtax exemptions" for such years and that they are allowable for the purpose of the normal tax as well as the surtax for such years, the provisions of paragraph (b) of this section are applicable thereto.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 15, T. D. 5517, 11 F. R. 6532]

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

§ 29.25-5 *Personal exemption of married person for taxable years beginning before January 1, 1944.* In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the Internal Revenue Code must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together within the meaning of the Code, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption. For taxable years beginning after December 31, 1943, the personal exemption, as such, of married persons is not applicable. There are substituted therefor, in the case of taxable years beginning after December 31, 1943, and before January 1, 1946, the normal-tax exemption and the surtax exemptions. In the case of taxable years beginning after December 31, 1945, the exemptions under section 25 (b) for both normal tax and surtax are applicable. See § 29.25-3.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 15, T. D. 5517, 11 F. R. 6532]

§ 29.25-6 *Credit for dependents*—(a) *Taxable years beginning before January 1, 1944.* (1) For taxable years beginning before January 1, 1944, a taxpayer, other than a nonresident alien who is not a resident of Canada or Mexico (see section 214), receives a credit of $350 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (i) under 18, or (ii) incapable of self-support because defec-

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tive. For credit for dependents in computing tax under Supplement T, see sections 400 and 401.

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

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

(b) *Taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, the provisions of paragraph (a) of this section have no application. For exemptions for dependents for such taxable years, see § 29.25-3.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 15, T. D. 5517, 11 F. R. 6532]

§ 29.25-7 *Personal exemption and credit for dependents where status changes during taxable years beginning before January 1, 1944.* (a) If the status of the taxpayer changes during a taxable year beginning before January 1, 1944, the personal exemption allowed by section 25 (b) (1) to a single person, a married person not living with husband or wife, a head of a family, or a married person living with husband or wife, and the credit for dependents allowed by section 25 (b) (2) will be apportioned according to the number of months during which the taxpayer occupied each status. A taxpayer not having the status of a head of a family or the status of a married person living with husband or wife shall be considered as having the status of a single person. For the purpose of the apportionment of the personal exemption and credit for dependents a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month. In general, the personal exemption and credit for dependents allowable to any taxpayer will be the sum of the amounts apportioned to the several periods of the taxable year during which each status was occupied.

(b) The return for the period in which falls the date of the death of a taxpayer is a return only for the period during which the taxpayer was alive. The personal exemption and credit for dependents must be determined for taxable years beginning before January 1, 1944, on the basis of the period for which the return was made. If during such period the status of the taxpayer did not change, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in such period bears to 12 months. (See § 29.47-1.) If the status of the taxpayer changed during such period, the full personal exemption and credit for dependents allowable for each status occupied by the taxpayer shall be apportioned to the period during which such status was occupied in such proportion as the number of months during which such status was occupied bears to 12 months.

Example (1). A and B, who were heads of families during the first six months of 1942, were married on July 1, 1942, and lived together during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1942, the personal

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

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

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

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5373, 9 F. R. 5501]

§ 29.26-1 *Credit of corporation for interest on obligations of the United States and its instrumentalities.* The credit allowed by section 26 (a) is an amount equal to the interest received upon obligations of the United States or of a corporation organized under act of Congress (if such corporation is an instrumentality of the United States and under the act authorizing the issue of such obligations, as amended and supplemented, such interest is in the case of individuals exempt from normal tax) which is included in gross income under section 22.

§ 29.26-2 *Credit of corporation for net operating loss of preceding year.* (a) Since the net operating loss credit allowed by section 26 (c) cannot exceed the section 102 net income for the taxable year, in the case of the tax imposed by section 102; the Supplement P net income for the taxable year, in the case of the computations required under Supplement P; or the subchapter A net income for the taxable year in the case of the tax imposed under subchapter A of chapter 2, it is the smaller of the following amounts:

(1) The excess of the deductions allowed by chapter 1 for the preceding taxable year over gross income for such year, both computed in accordance with the exceptions and limitations provided by section 26 (c) (2).

(2) (i) The section 102 net income for the taxable year, in the cases of the tax imposed by section 102; (ii) the Supplement P net income for the taxable year, in the case of the computations required under Supplement P; (iii) the subchapter A net income for the taxable year, in the case of the tax imposed under subchapter A of chapter 2.

(b) In computing deductions for the preceding taxable year any deduction for depletion shall be computed without reference to discovery value or percentage depletion under section 114 (b) (2), (3), or (4) (see § 29.23 (m)-2). The basis for such depletion is the basis provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain upon the sale or other disposition of the property involved.

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

(d) In computing the gross income for the preceding taxable year there must be included the excess, if any, of the amount of any interest received which is wholly exempt from taxes imposed by

chapter 1 over the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

Example. For 1942 the X Corporation, which makes its income tax returns on the calendar year basis, has a net income of $1,000,000, computed on the accrual basis and without the net operating loss deduction provided in section 23 (s), capital losses of $550,000, and no capital gains. Its Federal normal tax and surtax for 1942, not allowable as a deduction under section 23, are $300,000, and it made no contributions during that year. For 1941 its gross income was $500,000, and its allowable deductions were $1,500,000. Included in such deductions was $500,000 for net operating loss, allowed as a deduction under section 23 (s) and computed under section 122. There was likewise included in such deductions $300,000 for depletion based on discovery value. If depletion had been computed without reference to discovery value or to percentage depletion, the amount of such deduction would have been $100,000. For 1941 the corporation had $300,000 of wholly tax-exempt interest, and paid $200,000 in interest on indebtedness incurred to carry obligations from which such tax-exempt interest was derived. The net operating loss credit available to such corporation for 1942 is computed as follows:

Deductions for 1941		$1,500,000
Less excess of depletion deduction computed on basis of discovery value over amount allowable for depletion without reference to discovery value or percentage depletion ($300,000 minus $100,000)	$200,000	
Less net operating loss deduction	500,000	
		700,000
Deductions as limited by section 26 (c) (2) (A) and 26 (c) (2) (C)		800,000
Gross income for 1941	$500,000	
Plus tax-exempt interest minus interest paid ($300,000 minus $200,000)	100,000	
Gross income contemplated by section 26 (c) (2) (B)		600,000
Excess of deductions over gross income for 1941		200,000
Net income for 1942 (computed without net operating loss deductions provided in section 23 (s))		1,000,000
Less capital losses not allowed by section 117 (d)	$550,000	
Less Federal normal tax and surtax for 1942 not allowed as a deduction under section 23	300,000	
		$850,000
Section 102 net income for 1042		150,000

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

(e) Similar rules for the computation of the net operating loss credit are applicable in the case of computations required under Supplement P, or the tax imposed under subchapter A of chapter 2.

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

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

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

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

(b) No credit is allowable under section 26 (d) for the amount readily marketable assets in excess of what is required by such section 5144 to be acquired by such affiliate, or in excess of the adjusted net income for the taxable year. Nor may the aggregate of the credits allowable under section 26 (d) exceed the

amount required to be devoted under section 5144 to the acquisition of readily marketable assets other than bank stock.

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

§ 29.26-4 *Credit for income subject to excess profits tax.* (a) For taxable years beginning before January 1, 1946, a credit is provided in section 26 (e) allowable under sections 13 (a) (2) and 15 (a) in computing normal tax net income and surtax net income, respectively. See section 108 as to certain fiscal years. The credit is allowed only in the case of corporations subject to the excess profits tax imposed by subchapter E of chapter 2. The credit does not apply to a corporation exempt from such tax under section 725 (relating to personal service corporations) or section 727 (relating to corporations exempt from excess profits tax).

(b) In general, the credit is the amount of the corporation's adjusted excess profits net income, as defined in section 710 (b).

(c) In the case of the following corporations, however, the credit with respect to taxable years beginning prior to January 1, 1944, is an amount of which the excess profits tax imposed by subchapter E of chapter 2 is 90 percent, and, with respect to taxable years beginning after December 31, 1943, is an amount of which such excess profits tax is 95 percent:

(1) Corporations computing such excess profits tax under section 721, relating to abnormalities in income in the taxable period.

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

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

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

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

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

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

(f) If the excess profits tax of a corporation imposed by subchapter E of chapter 2 for a taxable year beginning after December 31, 1941, is finally determined by the use of the excess profits

credit based upon constructive average base period net income determined under section 722, or if the corporation is entitled to and uses such excess profits credit in the computation of its excess profits tax for such year without the necessity of filing an application for relief on Form 991 (revised January, 1943) under section 722 (see § 35.722-5 (d) of this chapter), the credit under section 26 (e) allowable in computing the normal tax and surtax shall be the amount of the corporation's adjusted excess profits net income, as defined in section 710 (b), computed with the use of the excess profits credit based upon constructive average base period net income.

However, if such corporation computes its excess profits tax as provided in paragraph (c) (1)-(4) of this section, the credit under section 26 (e) with respect to taxable years beginning prior to January 1, 1944, shall be the amount of which the excess profits tax imposed by subchapter E of chapter 2, computed as provided by the second paragraph of this section, is 90 percent, and with respect to taxable years beginning after December 31, 1943, shall be the amount of which such excess profits tax so computed is 95 percent.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5401, 9 F. R. 10449, T. D. 5517, 11 F R. 6532]

§ 29.26-5 *Credit for dividends paid on preferred stock of public utilities*—(a) *In general.* (1) The credit provided in section 26 (h), except as provided in paragraph (b) of this section for taxable years beginning after December 31, 1943, is an amount equal to the dividends paid during the taxable year by certain public utility corporations on certain classes of preferred stock. As used in this section, the term "public utility" means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established, by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The credit provided in section 26 (h) will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (i) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region, in one or more States and (ii) that the regulation to which it is subject in part of its operating territory is effective to control rates within the unregulated territory so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(2) For the purposes of section 26 (h) preferred stock means stock which was issued prior to October 1, 1942 except as provided in paragraph (c) of this section for taxable years beginning after December 31, 1943, and which during the whole of the taxable year (or the part of the taxable year after its issue) was stock nonparticipating as to earnings or profits either currently or in liquidation, the dividends in respect of which were cumulative and payable in preference to the payment of dividends on other stock. In addition, the preferred stock must be such that the rate of return is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the credit provided in section 26 (h) shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial

for the purposes of this section whether the stock be voting or nonvoting stock.

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

(b) *Amount of credit for taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending prior to October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility states that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending prior to October 1, 1942, a public utility may, however, receive credit for dividends paid with respect to the current taxable year. If there are no dividends unpaid and accumulated with respect to a taxable year ending prior to October 1, 1942, a public utility may receive credit for dividends paid with respect to a prior taxable year which ended after October 1, 1942; and such credit may be in addition to a credit for dividends paid with respect to the current taxable year. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility will not receive credit for any distribution in the current taxable year to the extent that there are dividends unpaid and accumulated with respect to taxable years ending prior to October 1, 1942.

(c) *Stock issued on or after October 1, 1942.* (1) In the case of taxable years beginning after December 31, 1943, stock issued on or after October 1, 1942 under certain circumstances will be considered as having been issued prior to October 1, 1942 for purposes of the credit provided in section 26 (h). If the new stock is issued on or after October 1, 1942 to refund or replace bonds or debentures which were issued prior to October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 26 (h) (2) (B), such new stock shall be considered as having been issued prior to October 1, 1942. If stock is issued to refund or replace stock which was preferred stock within the meaning of section 26 (h) (2) (B), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942 to refund or replace stock, which was issued prior to October 1, 1942 and which was preferred stock within the meaning of section 26 (h) (2) (B), is not itself preferred stock within the meaning of section 26 (h) (2) (B), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the credit provided in section 26 (h).

(2) In the case of any stock issued on or after October 1, 1942 to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 26 (h) (2) (B), only that portion of the stock issued on or after October 1, 1942 will be considered as having been issued prior to October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942 shall be earmarked in determining the credit allowable under section 26 (h), but the appropriate allocable portion of the total amount of dividends paid on such stock will be allowable as a credit under such section.

Example. If a public utility has outstanding 1,000 bonds which were issued prior to October 1, 1942 and each of which has a face value of $100 and if on or after October 1, 1942 each of such bonds is retired in exchange for one and one-tenth shares of stock issued on or after October 1, 1942 and having a par value of $100 per share, only ten-elevenths of the dividends paid on the stock thus issued

in exchange for the bonds will be considered as having been paid on stock which was issued prior to October 1, 1942. If a dividend of $6 a share is paid on such stock during the taxable year, a credit of $6,000 will be allowable under the provisions of section 26 (h). Likewise, if stock which is issued on or after October 1, 1942 has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued prior to October 1, 1942. If a total of $27,000 is paid as a dividend on such new stock during the taxable year a credit of $18,000 will be allowable under the provisions of section 26 (h).

(3) Whether or not stock issued on or after October 1, 1942 was issued to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued prior to October 1, 1942, issues new stock on March 1, 1944 in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on April 1, 1944, such stock may be considered as having been issued to refund or replace bonds issued prior to October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(4) Stock issued on or after October 1, 1942 by a corporation to refund or replace bonds or debentures of a second corporation which were issued prior to October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued prior to October 1, 1942 if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 112 (g) (1); or (ii) in a transaction to which section 112 (b) (10), relating to reorganization of certain insolvent corporations, or so much of section 112 (d) or (e) as relates to section 112 (b) (10), is applicable; or (3) in a transaction which is subject to the provisions of Supplement R, relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued prior to October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 112 (g) (1), in a transaction to which section 112 (b) (10), or so much of section 112 (d) or (e) as relates to section 112 (b) (10), is applicable, or in a transaction which is subject to the provisions of Supplement R. The provisions of this subsection, in addition, are applicable in case a corporation issues stock on or after October 1, 1942 to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated in this subparagraph.

(5) Even though stock issued on or after October 1, 1942 is considered as hav-

ing been issued prior to October 1, 1942 by reason of having been issued to refund or replace bonds or debentures issued prior to October 1, 1942, or to refund or respect of dividends paid on such stock, will not be deemed to be preferred stock within the meaning of section 26 (h) (2) (B), and no credit will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 26 (h) (2) (B) and in paragraph (a) of this section.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5384, 9 F. R. 7370]

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

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

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

(b) The deficit credit provided by section 27 (a) (3) and the credit for amounts used or irrevocably set aside to pay or to retire indebtedness as provided in section 27 (a) (4) have no application to taxable years beginning after December 31, 1941, covered by this part.

[T. D. 5460, 10 F. R. 7524]

§ 29.27 (b)-1 *Basic surtax credit.* The amount constituting the basic surtax credit of a corporation for the taxable year consists of the sum of the following, less the amount allowable as a credit under section 26 (h) (relating to the credit for dividends paid on certain preferred stock of certain public utility corporations), and less the amount allowable as a deduction under section 121 (relating to the deduction of dividends paid on certain preferred stock of certain banks and trust companies):

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

(b) The smaller of the following:

(1) The sum of the net operating loss credit for the preceding taxable year provided in section 26 (c) (1) and the bank affiliate credit provided in section 26 (d).

(2) (i) The section 102 net income for the taxable year, in the case of tax imposed by section 102; (ii) the Supplement P net income for the taxable year, in the case of computations required under Supplement P; or (iii) the subchapter A net income for the taxable year, in the case of tax imposed under subchapter A of chapter 2.

§ 29.27 (b)-2 *Dividends paid*—(a) *When dividends are considered paid.* (1) A dividend will be considered as paid when it is received by the shareholder. An allowance for dividends paid will not be permitted unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

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

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

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

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

(6) In the case of a stock dividend, if the shares (other than fractional shares payable to bearer) constituting the dividend are not entered or registered on the books of the corporation in the name of the shareholder (or his nominee or trans-

feree) within the taxable year, the dividend will not be deemed to have been paid in such year. Delivery of a certificate, or certificates, for such new shares, within the taxable year, constitutes prima facie evidence of the payment of the dividend.

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

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

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

(c) *Records.* Every corporation claiming an allowance for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such allowance is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (*a*) the medium of payment and (*b*), if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed, and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

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

(1) If the basic surtax credit for the first preceding taxable year exactly equals the subchapter A net income for such year, the dividend carry-over is the amount of the excess of the basic surtax credit for the second preceding taxable year over the subchapter A net income for such year.

(2) If the basic surtax credit for the first preceding taxable year exceeds the subchapter A net income for such year, the dividend carry-over is the amount of such excess plus the excess of the basic surtax credit for the second preceding taxable year over the subchapter A net income for such year.

(3) If the basic surtax credit for the first preceding taxable year is less than the subchapter A net income for such year, the dividend carry-over is the amount by which the basic surtax credit for the second preceding taxable year exceeds the subchapter A net income for such year reduced by the excess of the subchapter A net income for the first preceding taxable year over the sum of the basic surtax credit for such year and the excess of the basic surtax credit for the third preceding taxable year over the subchapter A net income for such year.

(b) In computing the dividend carry-over the subchapter A net income of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

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

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

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has subchapter A net income of $150,000 and a basic surtax credit of $225,000 for 1939. For 1940 its subchapter A net income is $200,000 and its basic surtax credit is $350,000, and for 1941 its subchapter A net income and its basic surtax credit are each

$175,000. Its dividend carry-over to 1942 is $150,000, computed as follows:

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

Since the basic surtax credit for 1941 exactly equals the subchapter A net income for that year, neither that year nor the year 1939 need be taken into account. The preceding taxable year (1941) is taken into account only if the basic surtax credit for such year exceeds the subchapter A net income for such year or if the subchapter A net income for such year exceeds the sum of the basic surtax credit for such year and the excess of the basic surtax credit for the third preceding taxable year (1939) over the subchapter A net income for such year. The third preceding taxable year (1939) is taken into account only if the subchapter A net income for the first preceding taxable year (1941) exceeds the basic surtax credit for such year, in which case it operates to reduce the amount of such excess which must be deducted from the carry-over from the second preceding taxable year (1940).

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has subchapter A net income of $100,000 and a basic surtax credit of $150,000 for 1939. For 1940 its subchapter A net income is $50,000 and its basic surtax credit is $75,000, and for 1941 its subchapter A net income and its basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1942 is $100,000, computed as follows:

Year 1940

(1) Basic surtax credit	$75,000	
(2) Less subchapter A net income	50,000	
(3) Excess of basic surtax credit over subchapter A net income		$25,000

Year 1941

(4) Basic surtax credit	$100,000	
(5) Less subchapter A net income	25,000	
(6) Excess of basic surtax credit over subchapter A net income		75,000
(7) Dividend carry-over to 1942 (sum of (3) and (6))		100,000

For the reason why the year 1939 is not taken into account, see explanation at end of example (1).

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis, has a subchapter A net income of $90,000, and a basic surtax credit of $150,000 for 1939. For 1940 its subchapter A net income is $60,000 and its basic surtax credit is $160,000, and for 1941 its subchapter A net income and its basic surtax credit are $120,000 and $25,000, respectively. Its dividend carry-over to 1942 is $65,000, computed as follows:

Year 1940

(1) Basic surtax credit	$160,000	
(2) Less subchapter A net income	60,000	
(3) Excess of basic surtax credit over subchapter A net income		$100,000

Year 1941

(4) Subchapter A net income	$120,000	
(5) Basic surtax credit	25,000	

Year 1939

(6) Basic surtax credit	$150,000	
(7) Less subchapter A net income	90,000	
(8) Excess of basic surtax credit over subchapter A net income	60,000	
Sum of (5) and (8)	85,000	
(9) Excess of subchapter A net income for the first preceding taxable year (1941) over sum of items (5) and (8)		35,000
(10) Dividend carry-over to 1942 ((3) minus (9))		65,000

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

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

(2) The fair market value of such property.

(b) As used in this section the term "property" includes shares of capital stock of the corporation making the dividend distribution if such shares of stock are held by it as an investment. Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment. The term "property" also includes obligations upon which the corporation making the distribution is liable as a guarantor, indorser, or surety.

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

Example. The S Corporation, in 1934, purchased stock of the Y Corporation for $100,000. In 1942 such stock had a fair market value of $70,000. During the period of its ownership of such stock, the S Corporation received distributions amounting to $5,000 out of earnings or profits of the Y Corporation accumulated before March 1, 1913. In 1942 the corporation used such stock for the payment of a dividend. The allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1942 is $70,000, computed as follows:

Purchase price, or cost of stock	$100, 000
Less tax-free distribution	5, 000
Adjusted basis of stock in the hands of the corporation at the time of the dividend payment	95, 000
Fair market value of stock at the time of the dividend payment	70, 000
Allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1942	70, 000

Since the fair market value of the stock ($70,000) at the time of the dividend payment is less than the adjusted basis ($95,000) of the stock in the hands of the corporation at the time of the dividend payment, the lesser amount ($70,000) should be used as the allowance for dividends paid for purposes of computing the basic surtax credit for 1942 with respect to such stock.

§ 29.27 (e)-1 *Dividends in obligations of the corporation.* (a) Section 27 (e) is concerned solely with the amount of the allowance for dividends paid for purposes of inclusion in the basic surtax credit to the extent that dividends are paid by a corporation in its own obligations. If the corporation ultimately pays a dividend in its own obligations (regardless of the form of the corporate resolution by which the dividend is declared), the amount of the allowance for dividends paid to which it is entitled with respect thereto for the year in which such dividend is paid is limited to the lesser of the face value or fair market value of such obligations as of the date of payment. If in a taxable year of the corporation beginning after December 31, 1935, the allowance for dividends paid as of the date of payment is limited to the fair market value of the corporate obligations distributed and the corporation redeems such obligations, the corporation becomes entitled to an additional allowance for dividends paid in computing the basic surtax credit for the taxable year in which it redeems such obligations, but only in the event that the amount at which such obligations are redeemed is higher than their fair market value at the time of the distribution. The amount of such additional allowance is the excess of the price at which such obligatians are redeemed over their fair market value at the time of the distribution, subject to the restriction that such excess be diminished by any amounts which were allowable as deductions for amortized bond discount or bond issue commissions and expenses allocable to the obligations redeemed in computing the net income of the corporation for any taxable year. A corporation is entitled to such additional allowance regardless of the identity of the holders of the obligations at the time of their redemption.

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

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

Example. The X Corporation, which makes its income tax returns on the calendar year basis, declared a dividend of $85,000 in 1936, payable in that year in its 5 percent bonds at 85. Pursuant to such declaration, bonds having an aggregate face value of $100,000

were issued during 1936 in payment of the dividend. The fair market value of the bonds at the time of issuance was $75,000. The dividends paid credit for 1936 was the fair market value of the bonds at the time of the dividend payment ($75,000), since such fair market value was lower than the face value ($100,000) of the obligations.

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

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

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

§ 29.27 (g)-1 *Dividends paid credit for distributions in liquidation*—(a) *Distributions which diminish earnings or profits.* (1) To the general rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27 (g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Internal Revenue Code, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if:

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

(ii) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized or the gain is taxed as provided in section 112 (b) (7).

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

(3) On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Internal Revenue Code, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Code as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Code. No allowance for dividends paid is permissible with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.* In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this section) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of this section, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which,

for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example. The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000, and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1942, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock, earnings or profits of $30,000 accumulated prior to March 1, 1913, and earnings or profits accumulated since February 28, 1913, of $75,000. On July 15, 1942, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Internal Revenue Code, such transaction being only a partial liquidation under section 115 (c). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is allowable as dividends paid.

(c) *Credit in respect of earnings or profits transferred under certain tax-free transactions.* If, as a result of one or more transactions described in section 112, a corporation's earnings or profits accumulated after February 28, 1913, and its undistributed earnings or profits of the taxable year, shall have become the earnings or profits of another corporation subject to distribution as dividends by such other corporation, any dividend paid by the transferee corporation during that portion of the transferor's taxable year subsequent to the consummation of such tax-free transaction may, subject to the provisions of section 115, be apportioned and allocated to the transferor as a distribution out of such earnings or profits of transferor. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated. For the purposes of the allowance for dividends paid, any such distribution so allocated shall be treated as a dividend paid only in the computation of the basic surtax credit allowable to the transferor, and must be consistently so treated by both corporations for the current and succeeding taxable years. Each corporation shall file as a part of its return for the taxable year involved (1) a statement setting forth concisely all of the material facts, including the date and the character of the transaction under section 112, the status at that time of the earnings or profits of both corporations, the date and amount of all dividend distributions subsequently made, and the particular distribution or portion thereof designated as effecting a distribution of the earnings or profits of the transferor corporation; and (2) a certified copy of the resolution of the board of directors of the transferee corporation with respect to the distribution. No allowance for dividends paid based upon such apportionment and allocation will be permitted unless the Commissioner is satisfied that the transferor corporation is entitled thereto pursuant to the provisions of this paragraph and that there has been a full compliance with the requirements of this paragraph. The provisions of this paragraph may be illustrated by the following example:

Example. The P Corporation, which makes its income tax returns on the basis of a fiscal year ending March 31, owned all of the capital stock of the S Corporation. The S Corporation, which makes its returns on the calendar year basis, was completely liquidated on December 1, 1942. At that time, the S Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $50,000, in addition to earnings or profits for 1942 of $20,000, and an adjusted net income of $45,000. It had paid no dividends prior to its liquidation. The P Corporation

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

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5356, 9 F. R. 4323]

§ 29.27 (h)-1 *Preferential distributions.* (a) Section 27 (h) imposes a limitation upon the general rule that a corporation is entitled to an allowance for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such allowance with respect to a distribution, regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 27 (h) is unqualified, except in the case of a partial distribution (see section 28 (a) (5) made in connection with a consent distribution as defined in section 28 (a) (4), if the entire distribution composed of such partial distribution and consent distribution (see section 28 (e)) is not preferential. The existence of a preference is sufficient to prohibit allowance regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation, or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to an allowance for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to an allowance for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. The term "distribution," as used in this section, includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (g).

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

Example (1). A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation, on July 15, 1942, declared a dividend of $5 a share payable in cash on August 1, 1942, to A. On September 15, 1942, it declared a dividend of $5 a share payable in cash on October 1, 1942, to B, C, and D. No allowance for dividends paid for the taxable year 1942 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1942, and October 1, 1942.

Example (2). The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1942, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No allowance for dividends paid is permissible under section 27 (h) with respect to such distribution.

Example (3). The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1942, the corporation distributes a dividend of $125, $50 to E and $75 to F. The corporation is entitled to no allowance for any part of such dividend paid, since there has been

a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 in its basic surtax credit as a dividend paid.

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

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

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

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

(b) The effect of section 27 (h) and (i) is that no allowance for dividends paid may be included in the basic surtax credit with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under chapter 1 for the period in which the distribution is made, receives a taxable dividend as a result of the distribution. (See also section 27 (g)).

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

Example (1). A, B, and C are shareholders of the Y Corporation, a personal holding company, which makes its returns on the basis of a fiscal year ending July 31. A is an educational corporation exempt from income tax under section 101. On July 15, 1944, the Y Corporation distributed $90,000 in cash to its shareholders, $30,000 to each. The Y Corporation had a deficit in earnings and profits as of the beginning of its taxable year in the amount of $200,000, but had a subchapter A net income for the taxable year in the amount of $90,000. Its earnings and profits for the taxable year were only $50,000. It was entitled under section 26 (c) (1) to a net operating loss credit of $30,000. B makes his return on the calendar year basis, but C makes his return on the basis of a fiscal year ending July 31. Since B is subject to taxation under the income tax provisions of the Code with respect to taxable receipts realized in July 1944, and since his taxable year began after December 31, 1943, the $30,000 distribution received by him from the Y Corporation will constitute a taxable dividend in his hands only to the extent of $20,000, the amount of $30,000 reduced by a proportionate part of the net operating loss with respect to the distribution on July 15, accordingly, will be entitled to an allowance for dividends paid in the amount of $80,000 with respect to the distribution on July 15.

Example (2). If the facts in the preceding example are the same, except that C makes his return on the calendar year basis, the Y Corporation is entitled to an allowance for dividends paid in the amount of $70,000 with respect to the distribution on July 15.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335, T. D. 5670, 13 F. R. 6883]

§ 29.28 (a) (1)-1 *Consent stock.* The term "consent stock," as defined in section 28 (a) (1), includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited. The application of section 28 (a) (1) may be illustrated as follows:

If in the case of the X Corporation there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class

A stock and class B stock are consent stock.

§ 29.28 (a) (2)-1 *Preferred dividends.* The term "preferred dividends," as defined in section 28 (a) (2), includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution (other than in liquidation) of which on any class of stock is a condition precedent to a further distribution (other than in liquidation) of earnings or profits. A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some other class or classes of stock than the one on which it is payable. The application of section 28 (a) (2) may be illustrated as follows:

If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, than class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

§ 29.28 (a) (3)-1 *Consent dividends day.* The term "consent dividends day" is defined in section 28 (a) (3). If there was no partial distribution (as defined in section 28 (a) (5)) payable during the last month of the corporation's taxable year, the consent dividends day is the last day of such taxable year. If there were one or more days during such last month on which was payable a partial distribution, the consent dividends day is the last of such days. The day upon which shareholders, under the terms of the resolution of the board of directors directing the distribution, are entitled to receive the distribution is the day it is payable.

§ 29.28 (a) (4)-1 *Consent distribution.* The term "consent distribution," as defined in section 28 (a) (4), does not include any actual distributions but is limited to the hypothetical distribution evidenced by shareholders' consents. The consent distribution equals the aggregate of all the amounts specified in the several consents, whether or not, if actually distributed, such amounts would have constituted in whole or in part a return of capital. Section 28 (a) (4) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, consisting of 500 shares, 200 of which are owned by A, and 300 by B. On December 15, 1942, the corporation distributes to A $5 per share, or $1,000. On December 31, 1942, B executes a consent to include $1,500 in his gross income as a taxable dividend. At the beginning of 1942 the corporation had no accumulated earnings or profits. For the taxable year 1942 the earnings or profits are $2,000. Nevertheless the corporation will be deemed to have made a consent distribution of $1,500 on December 15.

§ 29.28 (a) (5)-1 *Partial distribution.* The term "partial distribution," as defined in section 28 (a) (5), does not include preferred dividends even though payable on consent stock. The application of section 28 (a) (5) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, class A and class B, each of which is consent stock. Class A, consisting of 500 shares, is entitled to a preference of $3 per share, after which class B, consisting of 500 shares, is to receive $3 per share, whereupon class A and class B are entitled to share equally in any further distributions of earnings or profits. On December 15, 1942, the X Corporation distributes $6 per share or $3,000 on class A stock, and $3 per share or $1,500 on class B stock. Such distribution, to the extent of $1,500 paid on class A stock, is a partial distribution.

§ 29.28 (a) (6)-1 *Preferential distribution.* (a) A preferential distribution is an actual distribution (other than the distribution of a preferred dividend as defined in section 28 (a) (2)), or a consent distribution, or a combination of the

two, upon consent stock, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of consent stock as compared with any other class of consent stock. Such a preference exists if there is distributed to any shareholder (in proportion to the number of shares held by him) more or less than his pro rata part of a distribution as compared with the distribution made to any other shareholder of the same class, or if there is distributed to all the shareholders of one class of consent stock in the aggregate more or less than their pro rata part of a distribution as compared with the distribution made to all the shareholders of any other class of consent stock. If such preference exists, the entire distribution is preferential.

(b) Section 28 (a) (6) may be illustrated by the following examples:

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1942, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B each receives a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income but C agrees to include only $3,000, the consent distribution is preferential.

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1942, there is distributed on the class A stock $2 per share, or $1,000, and on the class B stock $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the distribution.

§ 29.28 (b)-1 *Payment of preferred dividends.* Section 28 (b) (1) provides that a corporation shall not be entitled to a consent dividends credit for any taxable year, regardless of compliance with other requirements of section 28, unless at the close of such year all preferred dividends (for the taxable year and, if cumulative, for prior taxable years) have been paid. Whatever form such payment takes, it must result in the complete discharge of the obligation of the corporation to pay such dividends. For what constitutes payment of a dividend before the close of the taxable year, see § 29.27 (b)-2. For what constitutes a preferred dividend see section 28 (a) (2). A preferred dividend will be considered paid for the purposes of this requirement, even though it is paid as part of a preferential dividend as defined in section 27 (h), and the corporation receives no credit for dividends paid in consequence thereof.

§ 29.28 (b)-2 *Liquidation of consent stock.* (a) A corporation is not entitled to a consent dividends credit for any taxable year in which it has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1942, 1,000 shares of class A stock, the dividend rights of which are limited to an annual return of $6 per share. It also has outstanding on that date 1,000 shares of class B stock, which is entitled to receive the entire amount of any distribution made of earnings or profits within the taxable year after the payment on class A of $6 per share. On April 1, 1942, the corporation makes a distribution in partial liquidation, whereby five shares of class B stock (consent stock) are canceled or redeemed. The corporation is barred from obtaining a consent dividends credit for the taxable year, regardless of compliance with other requirements of section 28. If, however, class A stock (not consent stock), instead of class B stock, had been canceled or redeemed in the liquidation, the corporation would not be barred, because of such liquidation, from obtaining a consent dividends credit.

(b) The mere purchase by a corporation of its own stock for investment is not, within the meaning of section 28 (b) (2), the taking of any step in, or in pursuance of a plan of, complete or partial liquidation and will not prevent a corporation from obtaining a consent dividends credit for the taxable year.

§ 29.28 (c)-1 *Amount of consent dividends credit.* (a) The consent dividends credit forms part of the basic surtax credit (see section 27 (b) (1). It consists of the amount which the corporation would be permitted to include in its basic surtax credit as a dividend paid if it had distributed to each shareholder

whose consent has been filed pursuant to section 28 (d), and each such shareholder had received, on the consent dividends day (see section 28 (a) (3)), an amount equal to the amount specified in such consent. The amount of the consent dividends credit, therefore, cannot exceed the sum of the amount specified in the several consents. It may, however, regardless of the fact that such amounts are treated and taxed in their entirety to the consenting shareholders as a dividend (see section 28 (f), be smaller than the sum of the specified amounts, because it is limited to the amount which would have been allowed as dividends paid if an actual distribution had been made.

(b) The provisions of section 28 (c) may be illustrated by the following example:

Example. The X Corporation which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year. Its earnings and profits for the calendar year 1942 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1942. The sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X Corporation on December 31, 1942, only $8,000 would have constituted a dividend. The allowance for dividends paid, includible in the computation of the basic surtax credit, would have amounted to only $8,000. The consent dividends credit of the corporation, therefore, is limited to $8,000.

§ 29.28 (d)-1 *Making and filing of consents.* (a) A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with these regulations and the instructions on the form or issued therewith and may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, i. e., the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. In the consent such person must agree:

(1) To include in his gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend; and

(2) If he is a shareholder who is taxable with respect to a dividend only if received from sources within the United States, that the specific amount stated in his consent shall be considered as a dividend received by him from sources within the United States.

(b) A consent may be made at any time not later than the due date of the corporation's income tax return for the taxable year for which the credit is claimed (see § 29.53-4) or such consent may be made at any time not later than one year after October 21, 1942, if the corporation was a personal holding company for the taxable year for which the credit is claimed. With such return, and not later than the due date thereof, or in the case of a personal holding company referred to in section 28 (d) (1), within one year after October 21, 1942, the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973, or Form 973A, in the case of a personal holding company, showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distribution made during the taxable year to shareholders, and giving all the other information required by the form.

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

(1) Cash;

(2) United States postal money order;

(3) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be recinded prior to presentation;

(4) A cashier's check of a domestic bank; or

(5) A draft on a domestic bank or a foreign bank maintaining a United States

agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

§ 29.28 (d)-2 *Consent distribution must be nonpreferential.* The application of section 28 (d) (3) may be illustrated as follows:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December, 15, 1942, the corporation distributes $600 to B and $100 to A. On December 31, 1942, A executes a consent to include $500 in his gross income as a taxable dividend, though such amount is not distributed to him. The X Corporation, assuming the other requirements of section 28 have been complied with, is entitled to a consent dividends credit of $500. Though considered by themselves, both the partial distribution of $700 and the consent distribution of $500 are preferential, when considered together they constitute a single nonpreferential distribution of $1,200.

§ 29.28 (d)-3 *Overpayments and deficiencies.* For the refund or credit of any overpayment, and the assessment or collection of any deficiency referred to in section 186 (h) of the Revenue Act of 1942, see § 29.504-6.

§ 29.28 (e)-1 *Consent and partial distributions to be considered together.* The rule provided in section 28 (e), that a consent distribution and a partial distribution are to be considered as having been made in connection with each other and as together forming parts of one entire distribution, is not limited to the purposes of section 28, but is applicable in connection with any of the purposes of chapter 1. Thus, such rule is to be applied to determine whether a partial distribution is a preferential dividend under section 27 (h). See § 29.27 (h)-1.

§ 29.28 (f)-1 *Taxability of amounts specified in consents.* (a) Once a shareholder's consent is filed, the full amount specified therein shall be included in his gross income as a taxable dividend, and, in cases where the shareholder is taxable on a dividend only if received from sources within the United States, shall be treated as a dividend so received; regardless of:

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

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

(3) Whether the corporation, as a result of filing such consents, is entitled to any consent dividends credit or to a smaller consent dividends credit than the sum of the amounts specified in the several consents.

(b) The ground upon which a consent dividends credit is denied the corporation does not affect the taxability to a shareholder whose consent has been filed of the amount specified in his consent. Thus, he is taxable on the full amount so specified, though the corporation receives no credit or a smaller credit than the sum of the amounts specified in the consents because the corporation has no earnings and profits or a smaller amount of earnings and profits than the sum of the amounts specified in the consents. The full amount specified in a shareholder's consent which has been filed is also taxable to him as a dividend though a consent dividends credit is denied the corporation because (1) preferred dividends have not been paid, (2) part or all of the consent stock has been in a state of liquidation at any time during the taxable year, (3) the distribution of which the consent distribution is a part is preferential, (4) a consenting shareholder who is taxable with respect to a dividend only if received from sources within the United States fails to agree that the amount specified in his consent shall be considered as a dividend received by him from sources within the United States, or (5) payment has not been made as required by section 28 (d) (5) and § 29.28 (d)-1.

§ 29.28 (g)-1 *Treatment of amount specified in consent of corporate shareholder.* From the standpoint of computing a shareholder's income for a taxable year relative to which he has agreed to include a specific amount in gross income, such amount is treated exactly as though such shareholder had received in cash a taxable dividend equal to the amount specified in his consent. There fore, in the case of a corporate shareholder, such amount shall be included in the computation of its earnings and profits for the taxable year and its accumulated earnings and profits as of the close of the taxable year. The effect of a corporate shareholder's consent upon the computation of its earnings and profits may be illustrated as follows:

Example. The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1942 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1942 amount to only $8,000, there being at the beginning of such year no accumulated earnings or profits. The Y Corporation must nevertheless include in its gross income $10,000 as a taxable dividend. Assume the Y Corporation to have begun the year 1942 with $5,000 accumulated earnings and profits, to have made no distributions during the year, and (without considering the amount specified in its consent) to have had neither profit nor loss during the year. Its earnings and profits for the year will be $10,000 and its accumulated earnings and profits at the close of the year will be $15,000.

§ 29.28 (i)-1 *Effect on basis of stock in hands of shareholders and capital account of corporation.* The application of sections 28 (h) and 28 (i) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned entirely by A and B in equal amounts. A makes a consent to include $50 in his gross income as a dividend, but B refuses to do so. The X Corporation therefore distributes $50 to B in cash during the last month of its taxable year 1942. The consent distribution evidenced by A's consent and the actual distribution to B are treated together, as though one distribution of $100 had been made. The earnings and profits of the X Corporation for 1942, however amount to only $80, there being at the beginning of such year no accumulated earnings or profits. If, therefore, the entire $100, which is the sum of A's consent distribution and B's actual distribution, had been actually distributed, 80 percent thereof would have been a dividend, includible in the X Corporation's basic surtax credit, and 20 percent a return of capital. Applying this principle to the facts stated, the following results are obtained:

(1) In the case of the X Corporation—

(*a*) Its consent dividends credit is $40, being 80 percent of the amount specified in A's consent;

(*b*) Its basic surtax credit, assuming it has no net operating loss in the preceding year and no bank affiliate credit, is $80, composed of a consent dividends credit of $40 and an allowance for dividends paid of $40;

(*c*) The amount of its accumulated earnings and profits as of the close of the taxable year is zero, because of the transfer of $40 (the amount of the consent dividends credit) from earnings and profits to capital account and the deduction of an additional $40 on account of dividends paid to B. If, therefore, in the following year the X Corporation has no earnings and profits but nevertheless makes a distribution to shareholders, no part of such distribution will be a dividend, but it will all constitute a return of capital.

(2) In the case of A—

(*a*) A is taxable on $50 as a dividend:

(*b*) The basis of his stock is increased by $40, his pro rata share, i. e., all, of the consent dividends credit.

(3) In the case of B—

(*a*) B is taxable on $40 as a dividend;

(*b*) The basis of his stock is reduced by $10.

§ 29.35-1 *Credit for tax withheld on wages.* (a) The tax deducted and withheld at the source upon wages under subchapter D of chapter 9 is allowable as a credit against the tax imposed by chapter 1 upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. See section 322. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under chapter 1 upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages. Similarly, if the wages of a minor child are includible in the gross income of a parent of such child, the amount of income tax withheld at the source on such wages shall be allowed as a credit against the tax imposed upon the parent.

(b) The credit shall be allowed against the tax imposed by chapter 1 for the taxable year of the recipient of the income which begins in such calendar year. If such recipient has more than one taxable year beginning in such calendar year, the credit shall be allowed against the tax for the last taxable year so beginning. [T. D. 5325, 9 F. R. 367]

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

§ 29.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computa-

tion of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

§ 29.41-2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 29.22 (c)-5.)

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 29.22 (c)-1 to 29.22 (c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 29.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 29.22 (a)-7 and 29.23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22 (d) and regulations thereunder with respect to changing to optional method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The requirements in paragraphs (a) to (d) of this section relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in § 29.44-1, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In case where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

§ 29.41-3 *Methods of accounting.* It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and § 29.54-1.) Among the essentials are the following:

(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22 (c) and §§ 29.22 (c)-1 to 29.22 (c)-8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

§ 29.41-4 *Accounting period.* The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. (See § 29.46-1.)

§ 29.42-1 *When included in gross income*—(a) *In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See §§ 29.41-1 to 29.41-3, inclusive.) (As to income from noninterest-bearing obligations issued at discount, see § 29.42-6, and as to income from short-term obligations issued on a discount basis, see § 29.42-7.) If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regard-

less of the date when the amounts were charged off. (See § 29.23 (k)-1.) Except as otherwise stated in this paragraph, such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendeed on the basis of cash receipts and disbursements. In the case of a termination of a war contract as defined by section 3 of the Contract Settlement Act of 1944 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy), if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year.

(b) *Last taxable year of decedent.* If the taxable year in which falls the date of the death of a taxpayer began on or after January 1, 1943, then there shall be included in computing net income for such year only amounts properly includible under the approved method of accounting followed by the taxpayer, or, if the taxpayer followed no such method, only amounts received during such year. However, if the taxpayer followed the accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing net income for such year, except that, if the taxpayer was a member of a partnership, his share of the partnership income for the partnership year ending with its dissolution on account of his death shall be included in computing his net income. The approved accounting practice of the partnership in computing its income shall not be changed by reason of the taxpayer's death. Thus, if the partnership computed its income on the basis of cash receipts and disbursements, the partnership income for the year ending with the dissolution, a distributive share of which is included in the taxpayer's income, shall be so computed. If the partnership used the accrual method of accounting, its income shall be computed according to such practice. For example, if a law partnership keeping its books on the accrual method of accounting is entitled to certain contingent fees which are accrued only upon the completion of the cases involved, such partnership will compute its income for the year ending with its dissolution on account of the death of the taxpayer without accruing, on account of the death of the partner at such time, any such contingent fees in uncompleted cases. Under section 126, any distribution by the partnership to the estate or a beneficiary of the deceased partner out of such fees will be income to such estate or person. There must also be included in computing net income for the taxable year in which falls the date of death of a taxpayer the gain described in section 44 (d), relating to gain upon the disposition of installment obligations, except as otherwise provided in that section. See § 29.44-5. This amount must be included in computing net income regardless of the method of accounting followed by the taxpayer.

Section 134 (a) of the Revenue Act of 1942 changed the last sentence of section 42 (a) of the Internal Revenue Code to its present form. Prior to such change, the last sentence of section 42 (a) provided as follows:

> In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

Section 134 (f) of the Revenue Act of 1942 provides that the change in the last sentence of section 42 (a) shall be applicable to taxable years beginning after December 31, 1942. Section 134 (g) of the Revenue Act of 1942 provides that such change shall be applicable to taxable years beginning before January 1, 1943, if the executor, the administrator, or other personal representative of the taxpayer and the persons who acquire as beneficiaries of his estate or by reason of his death his right to receive any income make the election provided in such section 134 (g) (see § 29.126-4) to have the amendments made by section 134 apply to the law in effect for such taxable years. Accordingly, if the taxable year in which falls the date of the death of a taxpayer begins before Janu-

ary 1, 1943, the provisions of the first paragraph of this paragraph (b) are applicable only if such election has been made. See § 29.126-4, relating to such election and to the method of computing, and limitations with respect to, credit or refund of any overpayment which is a result of such election. If such election is not made, then there shall be included in computing net income for such taxable year, in addition to the amounts described in paragraph (a) of this section, all amounts accrued up to the date of the taxpayer's death which are not otherwise properly includible in respect of such taxable year or a prior taxable year, regardless of the fact that the decedent may have kept his books and made his return on the basis of cash receipts and disbursements.

[Regs. 111, 8 F. R. 14882, as amended by T. D 5405, 9 F. R. 11736]

§ 29.42-2 *Income not reduced to possession.* Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

§ 29.42-3 *Examples of constructive receipt.* If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. The amount of defaulted coupons is income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. If a dividend is declared payable on December 31 and the corporation intended to and did follow its practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been unqualifiedly made subject to the demand of the shareholders prior to January, when the checks were actually received. As to the distributive share of the profits of a partner in a partnership, see section 188. Interest credited on savings bank deposits, even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. If the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

§ 29.42-4 *Long-term contracts.* Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made

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during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

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

(c) A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in § 29.41-2.

§ 29.42-5 *Subtraction for redemption of trading stamps.* (a) If a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing:

(1) The total issue of stamps during each year;

(2) The total stamps redeemed in each year; and

(3) The rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year, regardless of the year when such redeemed stamps were issued.

(b) A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

§ 29.42-6 *Non-interest-bearing obligations issued at discount.* (a) If a taxpayer owns any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, and if the increase in redemption price of such obligation occurring in the taxable year does not constitute income for such year under the method of accounting used in computing his net income, the taxpayer may, at his election, treat such increase as constituting income for the year in which it occurs rather than in the year in which the obligation is disposed of, redeemed, or paid at maturity. The election must be made in the taxpayer's return, and may be made for any taxable year. The election shall apply also to all other obligations of the type described in this section owned by the taxpayer at the beginning of the first taxable year to which the election applies and to those thereafter acquired by him. It shall apply to the taxable year for which such return is filed, and shall be binding for all subsequent taxable years unless upon application by the taxpayer the Commissioner permits the taxpayer, subject to such conditions as the Commissioner deems necessary to change to a different method of reporting income from such obligations. Although the election, once made, is binding upon the taxpayer, it does not apply to a transferee of such taxpayer.

(b) In any case in which an election is made under this section, the amount considered to accrue in any taxable year to which the election applies is measured by the actual increases in the redemption price occurring in that year. Such amount shall not be considered to accrue ratably between the dates on which the redemption price changes. Thus, if two dates on which the redemption price increases fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount deemed to accrue in that year would be $1. If at the beginning of the first taxable year to which the election applies the taxpayer owns non-interest-bearing bonds of the prescribed character

acquired prior thereto, he is required to report in such year, in addition to the increases in the redemption price actually failing within that year, the total of the increases in such price occurring between the date of his acquisition and the beginning of such year.

Example. Throughout the calendar year 1945, a taxpayer who makes his income tax returns on the calendar year basis and computes his net income on the cash receipts and disbursements basis holds the following United States bonds:

(a) United States savings bonds having a maturity value of $10,000, which he purchased on January 1, 1938, for $7,500. The entire increase in the redemption price of these bonds is exempt from normal tax but only such part of the increase as is attributable to $5,000 in principal amount (purchase price) of such bonds is exempt from the surtax.

(b) United States Defense savings bonds, Series E, having a maturity value of $5,000, which he purchased on January 1, 1942, for $3,750. The increase in the redemption price of these bonds is subject to both the normal tax and the surtax.

(c) United States savings bonds, Defense Series F, having a maturity value of $10,000, which he purchased on January 1, 1944, for $7,400. The increase in the redemption price of these bonds is subject to both the normal tax and the surtax.

The taxpayer holds no other obligations of the type described in this section. In his return for 1945 the taxpayer elects to treat the increases in the redemption prices of such bonds occurring in such year as income to him for such year. Under this section he is required in such return to report with respect to such bonds $250 as subject to normal tax and $750 as subject to surtax, determined as follows:

	Subject to normal tax		Subject to surtax	
	Increases prior to 1945	Increases in 1945	Increases prior to 1945	Increases in 1945
Bonds acquired Jan. 1, 1938	None	None	$400	$100
Bonds acquired Jan. 1, 1942	$100	$100	100	100
Bonds acquired Jan. 1, 1944	None	50	None	50
Total	$250		$750	

In the case of the United States savings bonds acquired on January 1, 1938, the increases of $400 and $100 in the redemption price are attributable to the principal amount (purchase price) in excess of $5,000.

§ 29.42-7 *Short - term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill issued on or after March 1, 1941, and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill issued on or after March 1, 1941, for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 29.117-1.

§ 29.43-1 *"Paid or incurred" and "paid or accrued".* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (*c*).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete state-

ment of the facts upon which he relies. However, in his income tax return he shall take the deductions or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits charged against the amount so restricted shall be deemed to have been "paid or accrued" or "paid or incurred" proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See § 29.131–6 for the treatment of foreign income tax imposed with respect to such amount as a basis of credit for foreign income tax in such cases.

(b) The provisions of paragraph (a) of this section are in general applicable with respect to the taxable year during which the taxpayer dies if such taxable year begins on or after January 1, 1943. However, if the taxpayer followed the accrual method of accounting, there shall be included in computing net income for such year no amount accrued solely by reason of his death other than his distributive share of the losses of a partnership for the year ending with the dissolution of the partnership on account of his death. No change in the accounting practice of the partnership shall be made because of the taxpayer's death when the income and losses of the partnership are computed for the year ending with the dissolution of the partnership on account of the partner's death.

(c) Section 134 (b) of the Revenue Act of 1942 changed the last sentence of section 43 of the Internal Revenue Code to its present form. Prior to such change, the last sentence of section 43 read as follows:

> In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death (except deductions under section 23 (o) if not otherwise properly allowable in respect of such period or a prior period.

(d) Section 134 (f) of the Revenue Act of 1942 provides that the change in the last sentence of section 43 shall be applicable to taxable years beginning after December 31, 1942. Section 134 (g) of the Revenue Act of 1942 provides that such change shall be applicable to taxable years beginning before January 1, 1943, if the executor, the administrator, or other personal representative of the taxpayer and the persons who acquire as beneficiaries of his estate or by reason of his death his right to receive any income make the election provided in such section 134 (g) (see § 29.126–4) to have the amendments made by section 134 apply to the law in effect for such taxable years. Accordingly, if the taxable year in which falls the date of the death of a taxpayer begins before January 1, 1943, the provisions of the first paragraph of this paragraph are applicable only if such election has been made. See § 29.126–4, relating to such election and to the method of computing, and limitations with respect to, credit or refund of any overpayment which is a result of such election. If such election is not made, then there shall also be allowed as deductions and credits for such taxable year, in addition to the amounts described in paragraph (a) of this section, all amounts (except deductions under section 23 (o)) accrued up to the date of the taxpayer's death which are not otherwise allowable with respect to such taxable year or a prior taxable year, regardless of the fact that the decedent may have been required to keep his books and make his return on the basis of cash receipts and disbursements.

§ 29.43–2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any

magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

§ 29.44-1 *Sale of personal property on installment plan.* (a) Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the installment plan. Dealers who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default:

(1) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(2) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) By conveyance to a trustee pending performance of the contract and subject to its provisions.

(b) The general purpose and effect being the same in all of these cases, the same rule is uniformly applicable. The general rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for, bears to the total contract price. Thus, the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment basis of returning income. But in the case of any taxpayer who, by an original return made prior to February 26, 1926, changed the method of reporting his net income for the taxable year 1924 or any prior taxable year to the installment basis, see section 705 of the Revenue Act of 1928. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued," as provided by sections 43 and 48. A dealer who desires to compute his income on the installment basis shall maintain books of accounts in such a manner as to enable an accurate computation to be made on such basis in accordance with the provisions of this section.

(c) The income from a casual sale or other casual disposition of personal property (other than property of a kind which should properly be included in inventory) may be reported on the installment basis only if (1) the sale price exceeds $1,000 and (2) the initial payments do not exceed 30 percent of the selling price.

(d) If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also § 29.44-5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession, unless it is clearly shown that after the property was repossessed the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the repossession. (See also § 29.23 (k)-1.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The property repossessed shall be carried on the books of the vendor at its fair market value at the time of repossession.

(e) If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursement basis, such a course is permissible.

§ 29.44-2 *Sale of real property involving deferred payments.* (a) Under section 44 deferred-payment sales of real property include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) Such sales, either under paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in §§ 29.44-1 and 29.44-3, and in this section. The term "initial payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "selling price." The term "initial payments" contemplates at least one other payment in addition to the initial payment. If the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income

may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.

§ 29.44-3 *Sale of real property on installment plan.* (a) In transactions included in § 29.44-2 (a) (1) the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

(b) If the purchaser defaults in any of his payments, and the vendor returning income on the installment basis reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. (See also § 29.44-5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. (See § 29.23 (k)-1.) If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

(c) If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated a deferred-payment sales not on the installment plan.

§ 29.44-4 *Deferred-payment sale of real property not on installment plan.* (a) In transactions included in § 29.44-2 (a) (2), the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

(b) If the vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (a) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (b) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession, of fixed improvements placed on the property by the purchaser. If the vendor has previously transferred

title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income, and if the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if collectible, except that if the obligations satisfied are securities (as defined in section 23 (k) (3) and section 117 (f)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of section 117. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition including the fair market value of the fixed improvements placed on the property by the purchaser. See § 29.23 (k)-3 with respect to property reacquired in a foreclosure proceeding.

(c) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5453, 10 F. R. 7335]

§ 29.44-5 *Gain or loss upon disposition of installment obligations.* (a) The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the Internal Revenue Code unless the disposition is within one of the exceptions made by the Code. Such an exception is provided in section 44 (d) with respect to distributions under section 112 (b) (6), and in section 112 (b) (4) and (5) with respect to exchanges.

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

Example (1). In 1940 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1918 at a cost of $10,000. During 1940 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1942, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1942 is $5,500, computed as follows:

Proceeds of sales of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Excess of face value of notes over amount of income returnable were the notes satisfied in full		7,500
Taxable income to be reported for 1942		5,500

Example (2). Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1942 to its shareholders as a dividend, and at the time of such distribution the fair market value of the notes was $14,000. The income to be reported for 1942 is $6,500, computed as follows:

Fair market value of notes	$14,000
Excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1)	7,500
Taxable income to be reported for 1942	6,500

(c) If the taxpayer, referred to in the above examples (1) and (2) as Corporation M, had been an individual, the taxable income to be reported, shown above

as $5,500 and $6,500, respectively, would have been limited to 50 percent thereof by section 117 (b), the real estate having been held for more than 6 months prior to its sale in 1940. See also section 117 (c).

(d) In the case of a decedent who dies possessed of installment obligations, no gain on account of the transmission at death of such obligations is required to be reported as income in the return of the decedent for the year of his death, if the executor or administrator of the estate of the decedent or any of the next of kin or legatees files with the Commissioner a bond on Form 1132 conditioned upon the return as income, by any person receiving any payment in satisfaction of such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and received such payment. The bond shall be subject to the approval of the Commissioner, shall be in an amount sufficient in his judgment to insure collection of the tax resulting from the fulfillment of the conditions stated in the bond, and shall be filed at the time of filing the return for the decedent for the year of his death or at such later time as may be specified by the Commissioner. A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary as an acceptable surety on Federal bonds. In lieu of surety or sureties there may be deposited bonds or notes of the United States.

(e) 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.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5334, 9 F. R. 2434]

§ 29.45-1 *Determination of the taxable net income of a controlled taxpayer*—(a) *Definitions.* When used in this section:

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

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

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and ac-

counting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income deductions, credits, or allowances or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5426, 10 F. R. 24]

§ 29.46-1 *Change of accounting period.* If a taxpayer (other than a subsidiary corporation required to change its accounting period by reason of the provisions of § 23.14 of this chapter or 26 CFR, 1943 Cum. Supp., 33.14) changes his accounting period he shall, prior to the expiration of 30 days from the close of the fractional part of the year for which a return would be required to effect the change, furnish to the collector, for transmission to the Commissioner, the information required on Form 1128. However, if the fractional part of the year for which a return would be required to effect the change ends after July 31, 1943, such taxpayer shall, before using the new period for income tax purposes, secure the consent of the Commissioner, and application for permission to change the accounting period shall be made direct to the Commissioner on Form 1128 at least 60 days prior to the close of the fractional part of the year for which a return would be required to effect the change. If a change of accounting period of a subsidiary is required for income tax purposes under § 23.14 of this chapter or for excess profits tax purposes under 26 CFR, 1943 Cum. Supp., 33.14, the information required on Form 1128 shall be furnished by the subsidiary at or before the time of filing the consolidated income tax return or the consolidated excess profits tax return, as the case may be. For the due date of returns for fractional parts of a year see § 29.53-1. Where a timely application is made to compute the net income of an individual taxpayer upon the basis of the same accounting period as that of such individual's spouse, permission so to compute net income will be granted even though such permission will allow the individual and his spouse to reduce their taxes by taking advantage of section 12 (d) (the so-called "income splitting" provision) through the filing of a joint return, so long as no other reason appears which is considered suffi-

cient by the Commissioner for denying such permission. If the change is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. (See section 47.)

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5614, 13 F. R. 2658]

§ 29.47-1 *Returns for periods of less than 12 months.* No return can be made for a period of more than 12 months. A separate return for a fractional part of a year is therefore required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns in the several cases are stated in section 47 (a). The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time, except as otherwise provided in §§ 29.53-1, 29.56-1, 29.217-1, 29.218-1, 29.235-1, and 29.236.1. If, for taxable years beginning after December 31, 1941, and before January 1, 1944, a return is made for a fractional part of a year, except where a return is made for a period of less than 12 months by reason of a change in accounting period, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in the period for which the return is made bears to 12 months. If, for taxable years beginning after December 31, 1943, and before January 1, 1946, a return is made for a fractional part of a year resulting from the termination by the Commissioner under section 146 of the taxable period, the normal-tax exemption and the surtax exemptions shall be reduced to that proportion of the full normal-tax exemption (in the case of the normal tax) and the full surtax exemptions (in the case of the surtax) which the number of months in the period for which the return is made bears to 12 months, but such exemptions shall not be reduced for a fractional part of a year otherwise resulting. If, for taxable years beginning after December 31, 1945, such a return is made, the exemptions for normal tax and surtax shall be similarly reduced. A return is required in the case of every taxable year beginning before January 1, 1946, which is a period of less than 12 months, if the gross income for such taxable year is greater than the personal exemption or the normal-tax exemption, as the case may be, for such taxable year as so reduced. A return is required in the case of every taxable year beginning after December 31, 1945, which is a period of less than 12 months, if the gross income for such taxable year is greater than one exemption for normal tax and surtax as so reduced. In the case of a return by a corporation for a fractional part of a year the credit provided by section 26 (e) for the income of the corporation subject to excess profits tax, for taxable years beginning before January 1, 1944, is considered the amount of which the excess profits tax of the corporation imposed for the taxable year computed without regard to the tax deferment under section 710 (a) (5) is 90 percent, and for taxable years beginning after December 31, 1943, and before January 1, 1946, the amount of which such excess profits tax so computed is 95 percent. As to the definition of tax imposed for taxable years beginning before January 1, 1946, see section 26 (e). For treatment of taxable years beginning in 1945 and ending in 1946, see § 29.108-2. In the case of a corporation whose excess profits tax for a taxable year of less than 12 months is computed under sections 721, 726, 731, or 736 (b), the credit provided by section 26 (e) shall be computed as provided in that section. (See § 29.26-4.) For the computation of such credit in case the net income of the corporation is placed on an annual basis, see § 29.47-2.

The return of a decedent for the taxable year in which falls the date of his death is a return for the period during which he was alive.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5373, 9 F. R. 5502, T. D. 5458, 10 F. R. 7335, T. D. 5517, 11 F. R. 6532]

§ 29.47-2 *Returns for period of less than 12 months on account of a change in accounting period*—(a) *Net income placed on annual basis and tax computed thereon.* (1) In the case of a return for a period of less than 12 months on account of a change in accounting period, section 47 (c) provides that the net income computed on the return for such short period shall be placed on an annual basis by multiplying the amount thereof by 12 and dividing by the number of months in

the short period. The tax is such part of the tax computed on such annual basis as the number of months in the period is of 12 months.

(2) In placing on an annual basis the net income of a corporation for a short period, the credit for dividends received is placed on an annual basis to correspond to the amount of dividends received included in the net income, which amount is placed on an annual basis when such net income is placed on an annual basis. Similarly, the credit for interest on United States obligations should reflect the amount of such interest as increased when such amount is placed on an annual basis as part of the net income which is placed on an annual basis. If the corporation computes its excess profits tax under section 711 (a) (3) (A), the credit provided in section 26 (e) for the adjusted excess profits net income of the corporation is determined with the excess profits net income placed on an annual basis under such section 711 (a) (3) (A). The credit for the adjusted excess profits net income so determined on an annual basis is applied against the net income after such net income has been placed on an annual basis.

(3) If the corporation computes its excess profits tax under section 711 (a) (3) (B), the credit provided in section 26 (e) is computed for taxable years beginning prior to January 1, 1944, as the amount of which the tax of the corporation imposed for the short period and computed under section 711 (a) (3) (B) without regard to the tax deferment under section 710 (a) (5) is 90 percent, and for taxable years beginning after December 31, 1943, and before January 1, 1946, the amount of which such excess profits tax so computed is 95 percent. As to the definition of tax imposed, see section 26 (e). In the case of a corporation whose excess profits tax for a taxable year of less than 12 months is computed under section 721, 726, 731, or 736 (b), the credit provided by section 26 (e) shall be computed as provided in that section. (See § 29.26-4.) This adjusted excess profits net income is placed on an annual basis by multiplying by 12 and dividing by the number of months in the short period, and the credit for the adjusted excess profits net income so determined on an annual basis is applied against the net income after such net income has been placed on an annual basis.

(4) The following examples illustrate the application of this paragraph:

Example. (1). A citizen of the United States made a return for a 10-month period ended October 31, 1942, on account of a change in accounting period. His net income including his earned net income for such 10-month period was $10,000 and his earned net income for such period was $4,000. He was entitled to a personal exemption of $1,200 but not to a credit for dependents. His tax for the period is $2,412.67, computed as follows:

Net income for 10-month period		$10,000.00
Multiplied by 12		120,000.00
Net income on annual basis ($120,000÷10)		12,000.00
Less: Personal exemption		1,200.00
Surtax net income		10,800.00
Earned net income for 10-month period	$4,000.00	
Multiplied by 12	48,000.00	
Earned net income on annual basis ($48,000÷10)	4,800.00	
Subtracting: Earned income credit (10 percent of $4,800)		480.00
Net income subject to normal tax		10,320.00
Normal tax (6 percent of $10,320)		619.20
Surtax on $10,800		2,276.00
Total tax on annual basis		2,895.20
Amount of tax for period ($2,895.20×10/12)		2,412.67

Example (2). The X Corporation made a return for the 8-month period ended August 31, 1942, on account of a change in accounting period. The net income of the corporation for such 8-month period was $72,000, including $4,000 interest on obligations of the United States described in section 26 (a) and $12,000 in dividends from a domestic corporation, for which the credit provided in section 26 (b) is applicable. The adjusted excess profits net income of the corporation for such period was $27,375, computed after the excess profits net income for such period was placed on an annual basis under section 711 (a) (3) (A), and its excess profits tax computed under such section was $16,402.50 $\left(\frac{243}{365} \times 90\right.$ percent of $27,375). The tax for the 8-month period is $16,460, computed as follows:

Net income for 8-month period	$72,000
Multiplied by 12	864,000
Net income on annual basis ($864,000÷8)	108,000
Less: Adjusted excess profits net income	27,375
Remainder	80,625

Dividends received, subject to the credit provided in section 26 (b)	$12,000	
Multiplied by 12	144,000	
Dividends received placed on annual basis ($144,000÷8)	18,000	
Subtracting: Credit provided in section 26 (b) for dividends received (85 percent of $18,000)		$15,300
Surtax net income		65,325
Interest on United States obligations subject to credit provided in section 26 (a)	$4,000	
Multiplied by 12	48,000	
Subtracting: Credit provided in section 26 (a) for interest placed on annual basis ($48,000÷8)		6,000
Normal tax net income		59,325
Normal tax on $59,325		14,238
Surtax on $65,325		10,452
Total tax on annual basis		24,690
Amount of tax for period ($24,690 × $\frac{8}{12}$)		16,460

If it had been assumed that the corporation had applied for the benefits of section 711 (a) (3) (B), and that the excess profits tax of the corporation was reduced under that section to $11,250, then in the above computations the credit for the adjusted excess profits net income of the corporation, applied against the $108,000 net income (as placed on an annual basis), would not be $27,375, the amount computed upon the application of section 711 (a) (3) (A), but would be $18,750, the adjusted excess profits net income computed on the basis of the excess profits tax determined under section 711 (a) (3) (B) and placed on an annual basis. The computation is as follows:

Excess profits tax for short period	$11,250
Adjusted excess profits net income for short period (amount of which excess profits tax is 90 percent, or $\frac{100}{90}\times$ $11,250)	12,500
Multiplied by 12	150,000
Adjusted excess profits net income on annual basis ($150,000÷8)	18,750

(b) *Tax for short period determined by annual income.* (1) If the taxpayer applies to the Commissioner in the manner provided in paragraph (c) of this section to have his tax computed under the provisions of section 47 (c) (2), and if the taxpayer establishes the amount of his net income for the 12-month period hereinafter described, then section 47 (c) (2) provides that the tax for the short period shall be reduced to an amount which is such part of the tax computed on the basis of the net income which the taxpayer has established for the 12-month period as the net income for the short period is of the net income for the 12-month period. If such amount, however, is greater than the tax computed under paragraph (a) of this section, the tax for the short period is the tax computed under paragraph (a) of this section. The 12-month period referred to above is the 12-month period beginning with the first day of the short period except that if the taxpayer (other than a corporation) is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has distributed substantially all its assets prior to the end of such 12-month period, then it is the 12-month period ending with the last day of the short period. If a corporation ceases business and distributes so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, it will be considered to have distributed substantially all of its assets.

(2) In computing the tax under section 47 (c) (2), the net income for the short period is not placed on an annual basis. The net income for the 12-month period is computed under the same provisions of law as are applicable to the short period, and is computed as if the 12-month period were an actual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, there shall be included in computing his income for the 12-month period his share of the partnership income for taxable years of the partnership ending with or during such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending after such 12-month period. In the case of a corporation, the credit provided by section 26 (e) for the adjusted excess profits net income of the corporation is computed for taxable years beginning prior to January 1, 1944, as the amount of which the excess profits tax imposed for such 12-month period, computed without regard to the tax deferment under section 710 (a) (5), is 90 percent, and for taxable years beginning after December 31, 1943 and before January 1, 1946, the amount of which such excess profits tax so computed is 95 percent. In the case of a corporation whose tax is computed under sections 721, 726, 731, or 736 (b), the credit provided by section 26 (e) shall be computed as provided in that section. See § 29.26-4. The excess

profits tax imposed for such 12-month period shall be computed as provided in section 26 (e), and is the excess profits tax for the short period plus, for any taxable year which includes only part of such 12-month period, such part of the excess profits tax for such taxable year as is allocable to the part of the 12-month period included in such taxable year. The excess profits tax for such a taxable year may, in general, be allocated to the 12-month period in such proportion as the excess profits net income computed for the part of the 12-month period included in the taxable year is of the excess profits net income computed for the taxable year. However, if some other method of apportionment will more clearly reflect the portion of the excess profits tax which is attributable to the part of the 12-month period included in the taxable year, such other method shall be used.

(3) If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect the income for the 12-month period. In the case of a taxpayer permitted or required to take inventories, the cost of goods sold during the part of the 12-month period included in the taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for the part of the 12-month period included in the taxable year is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation, engaged in the sale of merchandise, which has a short period from January 1, 1942, to September 30, 1942, is the calendar year 1942. The 3-month period October 1, 1942, to December 31, 1942, is a part of the fiscal year ending September 30, 1943. The cost of goods sold during such 3-month period is such part of the cost of goods sold during the entire fiscal year ending September 30, 1943, as the gross receipts from sales for such 3-month period are of the gross receipts from sales for the entire fiscal year. The Commissioner may, in granting permission to a taxpayer to change its accounting period, require as a condition to granting the change that, if the taxpayer is to obtain the benefits of section 47 (c) (2), it shall take a closing inventory upon the last day of the 12-month period. Such closing inventory will be used only for the purposes of section 47 (c) (2), and the taxpayer will not be required to use such inventory in computing the net income for the taxable year in which such inventory is taken.

(4) The tax for the short period may not be reduced under section 47 (c) (2) to an amount which is less than the tax for the short period computed on the basis of the net income for the short period without placing such net income on an annual basis. If the tax computed under section 47 (c) (2) by reference to the net income for a 12-month period is less than such amount, the tax may be reduced only to such amount.

(5) In computing the tax of a corporation for the short period without placing its net income on an annual basis, the adjusted excess profits net income of the corporation is, for the purpose of determining the credit under section (26) (e) for taxable years beginning prior to January 1, 1944, the amount of which the excess profits tax of the corporation imposed for the short period computed without regard to the tax deferment under section 710 (a) (5) is 90 percent, and for taxable years beginning after December 31, 1943, and before January 1, 1946, the amount of which such excess profits tax so computed is 95 percent. As to the definition of tax imposed, see section 26 (e). In the case of a corporation whose tax is computed under section 721, 726, 731, or 736 (b), the credit provided by section 26 (e) shall be computed as provided in that section. See § 29.26–4.

(6) The following examples illustrate the application of section 47 (c) (2):

Example (1). The facts are the same as in example (1) in paragraph (a) of this section. In the period from November 1, 1942, to December 31, 1942, the taxpayer has $1,000 net income, all of which is earned income. The net income for the 12-month period from January 1, 1942, to December 31, 1942, including the earned net income for such period, is, therefore, $11,000, of which $5,000 is earned income. The taxpayer files an application under the provisions of paragraph (c) of this section for a reduction of his tax to an amount computed on the basis of his actual net income for the 12-month period from January 1, 1942, to December 31, 1942. His tax is reduced to $2,292.73, computed as follows:

Net income for 12-month period January 1, 1942, to December 31, 1942		$11,000.00
Less: Personal exemption		1,200.00
Surtax net income		9,800.00
Less: Earned income credit (10 percent of $5,000)		500.00
Net income subject to normal tax		9,300.00
Normal tax (6 percent of $9,300)		558.00
Surtax on $9,800		1,964.00
Total tax on annual income		2,522.00
Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00	
Net income for 12-month period January 1, 1942, to December 31, 1942	11,000.00	
Amount of tax for 10-month period $\left(\frac{10,000}{11,000} \times \$2,522\right)$		2,292.73

The amount of tax that would be due if the income for the short period were not placed on an annual basis is $2,256, computed as follows:

Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00
Less: Personal exemption $\left(\frac{10}{12} \times \$1,200\right)$	1,000.00
Surtax net income	9,000.00
Less: Earned income credit (10 percent of $4,000)	400.00
Net income subject to normal tax	8,600.00
Normal tax (6 percent of $8,600)	516.00
Surtax on $9,000	1,740.00
Total tax period	2,256.00

Since the tax for the short period computed under section 47 (c) (2) by reference to the actual income for the 12-month period, or $2,292.73, is greater than the tax that would be due if the income for the short period were not placed on an annual basis, or $2,256, the tax for the short period is reduced to $2,292.73, the tax computed by reference to the income for the 12-month period.

Example (2). The facts are the same as in example (1) of this paragraph, except that during the period from November 1, 1942, to December 31, 1942, the taxpayer has no income, but has deductible business expenses of $1,000. His net income for the 12-month period from January 1, 1942, to December 31, 1942, including his earned net income, is, therefore, $9,000, of which $4,000 is earned income. The taxpayer files an application under paragraph (c) of this section for a reduction of his tax under the provisions of section 47 (c) (2). The tax computed on the basis of the net income for the period from January 1, 1942, to October 31, 1942, without placing such net income on an annual basis is $2,256 (see example (1)). The tax computed under section 47 (c) (2) by reference to the actual net income for the 12-month period from January 1, 1942, to December 31, 1942, is $2,062.22, computed as follows:

Net income for 12-month period January 1, 1942, to December 31, 1942		$9,000.00
Less: Personal exemption		1,200.00
Surtax net income		7,800.00
Less: Earned income credit (10 percent of $4,000)		400.00
Net income subject to normal tax		400.00
Normal tax (6 percent of $7,400)		444.00
Surtax on $7,800		1,412.00
Total tax on annual income		1,856.00
Net income for 10-month period January 1, 1942, to October 31, 1942	$10,000.00	
Net income for 12-month period January 1, 1942, to December 31, 1942	9,000.00	
Amount of tax for 10-month period $\left(\frac{10,000}{9,000} \times \$1,856\right)$		2,062.22

Since the tax computed on the basis of the net income for the short period without placing such net income on an annual basis, or $2,256, is greater than $2,062.22, the tax computed by reference to the actual net income for the 12-month period, the tax for the short period under section 47 (c) (2) is $2,256.

Example (3). The facts are the same as in example (2) in paragraph (a) of this section. The taxpayer applies to have its tax reduced under the provisions of section 47 (c) (2). During the 4-month period from September 1, 1942, to December 31, 1942, the X Corporation has $16,000 net income, including $3,000 dividends from a domestic corporation for which the credit provided in section 26 (b) is applicable and $1,000 interest on obligations of the United States described in section 26 (a), and its excess profits net income computed for such 4-month period is $12,000. The net income for the 12-month period from January 1, 1942, to December 31, 1942, is, therefore, $88,000. For such 12-month period, the dividends from domestic corporations for which the credit provided in section 26 (b) is applicable amount to $15,000, and the interest on United States obligations described in section 26 (a) amounts to $5,000. The excess

profits tax for the short period is $16,402.50. The excess profits tax for the taxable year from September 1, 1942, to August 31, 1943, which includes the last four months of the 12-month period, is $43,200, and the excess profits net income for such period is $96,000. The tax for the short period is reduced under section 47 (c) (2) to $15,489.61, computed as follows:

Net income for 12-month period January 1, 1942, to December 31, 1942		$88,000.00
Excess profits tax for 8-month period January 1, 1942, to August 31, 1942	$16,402.50	
Excess profits tax for fiscal year September 1, 1942, to August 31, 1943	43,200.00	
Excess profits net income for period September 1, 1942, to December 31, 1942	12,000.00	
Excess profits net income for fiscal year September 1, 1942, to August 31, 1943	96,000.00	
Portion of excess profits tax allocable to period September 1, 1942, to December 31, 1942 $\left(\frac{12,000}{96,000} \times \$43,200\right)$	5,400.00	
Excess profits tax imposed for 12-month period January 1, 1942, to December 31, 1942 ($16,402.50 + $5,400.00)	21,802.50	
Subtracting: Adjusted excess profits net income for 12-month period January 1, 1942, to December 31, 1942 (amount of which tax for 12-month period is 90 percent, or $\left(\frac{100}{90} \times \$21,802.50\right)$		24,225.00
Less: Dividends received credit provided by section 26 (b) (85 percent of $15,000)		12,750.00
Surtax net income		51,025.00
Less: Credit provided in section 26 (a) for interest on United States obligations		5,000.00
Normal tax net income		46,025.00
Normal tax on $46,025		10,767.75
Surtax on $51,025		8,164.00
Total tax on annual income		18,931.75

Net income for 8-month period January 1, 1942, to August 31, 1942	$72,000	
Net income for 12-month period January 1, 1942, to December 31, 1942	$88,000	
Amount of tax for 8-month period January 1, 1942, to August 31, 1942 $\left(\frac{72,000}{88,000} \times \$18,931.75\right)$		$15,489.61

The amount of tax that would be due if the income for the short period were not placed on an annual basis is $15,354.75, computed as follows:

Net income for 8-month period		$72,000.00
Excess profits tax for 8-month period	$16,402.50	
Subtracting: Adjusted excess profits net income (amount of which tax for period is 90 percent, or $\left(\frac{100}{90} \times \$16,402.50\right)$		18,225.00
Credit for dividends received (85 percent of $12,000)	10,200.00	
		28,425.00
Surtax net income		43,575.00
Less: Credit for interest on United States obligations		4,000.00
Normal tax net income		39,575.00
Normal tax on $39,575		8,768.25
Surtax on $43,575		6,586.50
Total tax for period		15,354.75

Since the tax for the short period computed under section 47 (c) (2) by reference to the actual income for the 12-month period, or $15,489.61, is greater than the tax that would be due if the income for the short period were not placed on an annual basis, or $15,354.75, the tax for the short period is reduced to $15,489.61, the tax computed by reference to the income for the 12-month period.

(c) *Application to compute tax under section 47 (c) (2).* A taxpayer desiring the benefit of section 47 (c) (2) must file an application therefor. If at the time the return for the short period is filed the taxpayer is able to determine that the 12-month period ending with the close of the short period will be used in the computations under section 47 (c) (2), then the tax on the return for the short period may be determined under the provisions of section 47 (c) (2). In such a case, an income tax return form covering the 12-month period shall be

attached to the return as a part thereof, and the return will then be considered the application for the benefits of section 47 (c) (2) required by that section. In all other cases, the taxpayer shall file its return and compute its tax as provided in paragraph (a) of this section, and the application for the benefits of section 47 (c) (2) shall be made in the form of a claim for credit or refund. The claim shall set forth the computation of the net income and the tax thereon for the 12-month period, and must be filed not later than the time prescribed for filing the return for the first taxable year ending with or after the twelfth month after the beginning of the short period. For example, the taxpayer changes its accounting period from the calendar year basis to the fiscal year basis ending September 30, and files a return for the period from January 1, 1942, to September 30, 1942. Its application for the benefits of section 47 (c) (2) must be filed not later than the time prescribed for filing its return for the first taxable year which ends on or after the last day of December 1942, the twelfth month after the beginning of the short period. In this case, the taxpayer must file its application not later than December 15, 1943, the time prescribed for filing the return for its fiscal year ending September 30, 1943. However, if it obtains an extension of time for filing the return for such fiscal year, it may file its application during the period of such extension. If the Commissioner determines that the taxpayer has established the amount of the net income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 47 (c) (2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5401, 9 F. R. 10449, T. D. 5517, 11 F. R. 6532]

RETURNS AND PAYMENT OF TAX

§ 29.51-1 *Individual returns*—(a) *In general*—(1) *Taxable years beginning before January 1, 1944.* For each taxable year beginning before January 1, 1944, a return of income shall be made by each citizen of the United States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, whether or not such citizen or resident is the head of a family or has dependents:

(i) If single or married but not living with husband or wife for any part of the taxable year, and if having for the taxable year a gross income (as defined in sections 22 and 116) of $500 or over, or such income is equal to, or in excess of, the credit allowed by section 25 (b) (1) and (3) (computed without regard to any credit to which he may be entitled as the head of a family). (See §§ 29.25-7 and 29.47-1.)

(ii) 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 gross income of $1,200 or over, 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 and the aggregate gross income of the two is $1,200 or over; or

(*c*) Such taxable year is a period of less than 12 months, if such individual has for the taxable year a gross income, and if the aggregate gross income of such individual and his or her spouse is equal to, or in excess of, the credit for personal exemption allowed by section 25 (b) (1) and (3). See §§ 29.25-7 and 29.47-1.

(iii) If married and living with husband or wife for any part of the taxable year but not at the close thereof, or if married and living with husband or wife at the close of the taxable year, but not during the entire taxable year, if no joint return is made, and if:

(*a*) Having for the taxable year a gross income equal to, or in excess of, the credit allowed him or her by section 25 (b) (1) and (3) (computed without regard to any credit to which he or she may be entitled as the head of a family (see § 29.25-7)), and the other spouse has no gross income; or

(*b*) Such individual and his or her spouse each has for the taxable year a gross income, and their aggregate gross income is $1,200 or over, or is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to any credit to which either or both may be entitled as the head of a family (see § 29.25-7)).

(2) *Taxable years beginning after December 31, 1943 and before January 1, 1946.* For each taxable year beginning after December 31, 1943 and before January 1, 1946, a return of income shall be made by each citizen of the United

States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, regardless of family or marital status, if such citizen or resident has for such taxable year a gross income of $500 or more, or a gross income in excess of the credit allowed by section 25 (a) (3), prorated as provided in section 47 (e).

(3) *Taxable years beginning after December 31, 1945.* For each taxable year beginning after December 31, 1945, a return of income shall be made by each citizen of the United States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, regardless of family or marital status, if such citizen or resident has for such taxable year a gross income of $500 or more, or a gross income in excess of the credit allowed by section 25 (b) prorated as provided in section 47 (e).

(b) *Joint returns.* (1) For taxable years beginning prior to January 1, 1944, 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. For taxable years beginning after December 31, 1943, a husband and wife occupying the marital status as of the last day of the taxable year may elect to make a joint return even though one of the spouses has no gross income or deductions, and even though the spouses are not living together at any time during the taxable year. If a joint return is made the tax shall be computed on the aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year. A joint return may not be made if either the husband or wife is a nonresident alien.

(2) A joint return of a husband and wife (if not made by an agent, see § 29.51-2) shall be signed by both spouses. An oath is not necessary, but both spouses shall verify the return as provided in section 51. If signed by one spouse as agent for the other, authorization for such action must accompany the return. (See § 29.51-2.) The spouse acting as agent for the other shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

(3) For returns by fiduciaries, see section 142; by partnerships, see section 187; and by nonresident alien individuals, see section 217. For time and place for filing returns, see section 53.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5373, 9 F. R. 5502, T. D. 5425, 10 F. R. 16, T. D. 5600, 13 F. R. 577]

§ 29.51-2 *Form of return*—(a) *Taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, the return shall be on Form 1040 except that it may be on short Form 1040A if (1) the gross income does not exceed $3,000 and consists wholly of salary, wages, compensation for personal services, dividends, interest, or annuities, (2) the return is made on a cash basis, and (3) the taxpayer (if not excluded by section 404) elects to pay the tax imposed by section 400 in lieu of the tax imposed by sections 11 and 12. The forms may be had from the collectors of the several districts. The return may be made by an agent if, by reason of illness, the person liable for making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the return. Whenever a return is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the income return, may submit a certified copy thereof in lieu of the authorization on Form 935. The taxpayer and his agent, if any, are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns. For returns of nonresident aliens, see §§ 29.217-1 and 29.217-2.

The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided at the top of the return for the name and address of the taxpayer. A taxpayer having a permanent business address may give that address as the

principal or mailing address, provided that the complete home or residential address is also given within the space provided.

(b) *Taxable years beginning after December 31, 1943 and prior to January 1, 1948*—(1) *General*. For taxable years beginning after December 31, 1943, and prior to January 1, 1948, the return shall be on Form 1040, except in the case of a taxpayer entitled to elect, and who so elects, to use the Form W-2 (Rev.) in accordance with the rules prescribed in paragraph (b) (2) of this section. A taxpayer, even though entitled to use Form W-2 (Rev.) for the taxable year may, nevertheless, use Form 1040 as his return. Such taxpayer otherwise entitled to use Form W-2 (Rev.) as his return for the taxable year but who does not desire to take the standard deduction provided in section 23 (aa) is required to use Form 1040 as his return for such taxable year. Use of the short Form 1040A is discontinued with respect to taxable years beginning after December 31, 1943 and prior to January 1, 1948. The provisions of paragraph (a) of this section insofar as they apply to the time and manner of making a return on Form 1040 are equally applicable to taxable years beginning after December 31, 1943 and prior to January 1, 1948.

(2) *Use of optional return on Form W-2 (Rev.); in general.* For taxable years beginning after December 31, 1943, and prior to January 1, 1948 an individual entitled to elect to pay the tax imposed by Supplement T (except a taxpayer making his returns on a fiscal year basis) may at his election use as his return Form W-2 (Rev.) provided his gross income is less than $5,000, consists entirely of remuneration for personal services performed by him as an employee, dividends, or interest, and his gross income from sources other than wages, as defined in section 1621 (a), does not exceed $100. A taxpayer who makes his return on a basis other than the cash receipts and disbursements basis may not use Form W-2 (Rev.) as his return. However, in the case of married persons domiciled in a community property State, Form W-2 (Rev.) may not be used as a return by either spouse unless the aggregate gross income of husband and wife meets the tests prescribed above and they make a combined return. If they desire to file separate returns, Form 1040 must be used.

An election to make a return on Form W-2 (Rev.) shall be exercised by properly executing and filing such form, together with all other Forms W-2 or W-2 (Rev.) received for the taxable year, with the collector on or before the due date of the taxpayer's return.

Form W-2, as distinguished from Form W-2 (Rev.), may not be used as the optional return. An individual who has been furnished by his employer with Form W-2 with respect to wages paid in 1944 and who, prior to the time prescribed for the filing of the return for that year, has not been furnished Form W-2 (Rev.) by his employer, may obtain from the collector a blank Form W-2 (Rev.). Such Form W-2 (Rev.) when filled out and executed and having attached thereto all Forms W-2 received with respect to wages paid in 1944, shall, when timely filed, constitute such individual's return for 1944 if he is eligible under section 51 (f) to use the optional return.

The fact that an individual made payments of estimated tax in the calendar year 1944 does not, if such individual is otherwise entitled to use as his return for 1944 the optional return, Form W-2 (Rev.), preclude such individual from electing to file his return on Form W-2 (Rev.) for such year.

(3) *Combined return of husband and wife on Form W-2 (Rev.).* If during the taxable year a husband and wife derive income from wages, as defined in section 1621 (a), and are furnished one or more Forms W-2 or Forms W-2 (Rev.), and the aggregate gross income of both spouses is less than $5,000, consists solely of remuneration for services performed as an employee, dividends, or interest, and includes a total of not more than $100 from dividends, interest, and remuneration for personal services other than such wages, the spouses may elect to file a combined return on Form W-2 (Rev.). Such election shall be exercised by the filing of one of the Forms W-2 (Rev.) signed by both spouses and the other Forms W-2 and W-2 (Rev.) should be attached thereto.

The tax computed by the collector upon the basis of a combined return on Form W-2 (Rev.) shall be the lesser of the following amounts:

(i) A tax computed as though the combined return on Form W-2 (Rev.) constituted the separate returns of the spouses, and

(ii) A tax computed as though the combined return on Form W-2 (Rev.) constituted a joint return.

If a combined return is made by husband and wife on Form W-2 (Rev.), the liability for the tax shall be joint and several.

(c) *Taxable years beginning after December 31, 1947*—(1) *General.* For taxable years beginning after December 31, 1947, the return shall be on Form 1040, except in the case of a taxpayer entitled to elect, and who so elects, to use the Form 1040A in accordance with the rules prescribed in subparagraph (2) of this paragraph. A taxpayer, even though entitled to use Form 1040A for the taxable year may, nevertheless, use Form 1040 as his return. Such taxpayer otherwise entitled to use Form 1040A as his return for the taxable year but who does not desire to take the standard deduction provided in section 23 (aa) is required to use Form 1040 as his return for such taxable year. The provisions of paragraph (a) of this section insofar as they apply to the time and manner of making a return on Form 1040 are equally applicable to taxable years beginning after December 31, 1947.

(2) *Use of optional return of Form 1040A; in general.* For taxable years beginning after December 31, 1947, an individual entitled to elect to pay the tax imposed by Supplement T (except a taxpayer making his returns on a fiscal year basis) may at his election use as his return Form 1040A provided his gross income is less than $5,000, consists entirely of remuneration for personal services performed by him as an employee, dividends, or interest, and his gross income from sources other than wages, as defined in section 1621 (a), does not exceed $100. A taxpayer who makes his return on a basis other than the cash receipts and disbursements basis may not use Form 1040A as his return. A taxpayer who has made payments of estimated tax for a taxable year may not use Form 1040A as his return for such year. In the case of married persons domiciled in a community property State, Form 1040A may not be used as a return by either spouse unless the aggregate gross income of husband and wife meets the tests prescribed above and they make a joint return. If they desire to file separate returns, Form 1040 must be used.

An election to make a return on Form 1040A shall be exercised by properly executing and filing such form, to which shall be attached all Forms W-2 received for the taxable year, with the collector on or before the due date of the taxpayer's return. Such Form 1040A, when filled out and executed and having attached thereto all Forms W-2 received with respect to wages paid in the taxable year, shall, when timely filed, constitute such individual's return for such year if he is eligible under section 51 (f) to use the optional return.

(3) *Joint return of husband and wife on Form 1040A.* If during the taxable year either husband or wife, or both, derive income from wages, as defined in section 1621 (a), and are furnished one or more Forms W-2, and the aggregate gross income of both spouses is less than $5,000, consists solely of remuneration for services performed as an employee, dividends, or interest, and includes a total of not more than $100 from dividends, interest, and remuneration for personal services other than such wages, the spouses may file a joint return on Form 1040A signed by both spouses, and all Forms W-2 received by both spouses for the taxable year should be attached thereto. The tax computed by the collector upon the basis of a joint return on Form 1040A shall be the lesser of the following amounts:

(i) A tax computed as though the return on Form 1040A constituted the separate returns of the spouses, and

(ii) A tax computed as though the return on Form 1040A constituted a joint return.

If a joint return is made by husband and wife on Form 1040A, the liability for the tax shall be joint and several.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 16, T. D. 5649, 13 F. R. 5049]

§ 29.51-3 *Return of income of minor*—(a) *Taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, an individual, although a minor, who is single, is required to render a return of income if he has a gross income of his own of $500 or over for the taxable year, regardless of the amount of his net income. If the aggregate of the gross income of such a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings which belong to him, is at least $500, regardless of the amount of his net income, a return, as in the case of any other individual, must be made by him or for him

by his guardian, or other person charged with the care of his person of property. (See § 29.142-2.) If he is married, see § 29.51-1. If under the laws of a State the earnings of a minor belong to the minor, such earnings, regardless of amount, are not required to be included in the return of the parent. In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return.

(b) *Taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, an individual, although a minor, who is single, is required to render a return of income if he has gross income (including compensation for personal services includible in his gross income under section 22 (m) (1)) of $500 or over for the taxable year regardless of the amount of his net income. If the aggregate of the gross income of such a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings is at least $500, regardless of the amount of his net income, a return, as in the case of any other individual, must be made by him or for him by his guardian or other person charged with the care of his person or property. See § 29.142-2. If he is married see § 29.51-1.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5425, 10 F. R. 16]

§ 29.51-4 *Verification of returns.* (a) A return of an individual required to be filed under section 51 shall contain or be verified by a written declaration that it is made under the penalties of perjury. All other income tax returns must be verified under oath or affirmation. The oath or affirmation may be administered by any person duly authorized to administer oaths for general purposes by the law of the United States or of any State, Territory, or possession of the United States, or of the District of Columbia, wherein such oath or affirmation is administered, or by a consular officer of the United States. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those respective services. Income tax returns executed abroad may be attested free of charge before United States consular officers. If a foreign notary or other foreign official having no seal should act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer.

(b) Income tax returns actually prepared by other persons for individuals required to file returns under section 51 shall be verified as provided in section 51. If any person or persons actually prepare any other income return for another person, the prescribed form of affidavit on the return shall be subscribed and sworn to by such person or persons preparing the return. Such affidavit is required on all such income returns required under the Internal Revenue Code except the following:

(1) Returns required under sections 143 and 144 (relating to withholding of tax at the source);

(2) Returns required to be made by departing aliens under section 146;

(3) Returns required under sections 147, 148, and 149 (relating to information at source);

(4) Returns by subsidiary corporations included in consolidated returns; and

(5) Returns required under sections 338 (a), 339, and 3604 (relating to monthly information returns filed by officers and directors, and also monthly and annual information returns filed by certain shareholders, of certain foreign corporations, and returns as to the formation of foreign corporations).

Such affidavit is not required if the actual preparation of the return is a regular and usual incident of the employment of one regularly and continuously employed for full time by the person for whom the return is made (as in the case of a clerk, secretary, bookkeeper, accountant, etc.). If, however, the employee is not regularly or continuously employed by the person for whom the return is made for the full time, or the actual preparation of the return is not a regular and usual incident of such employment, the requirements of this paragraph apply. Thus, if the return is prepared by an accountant or firm of accounts making periodical audits of the accounts of the person for whom the return is prepared, the affidavit is required. If the return is a separate return of a married person, the affidavit is required, although the one actually preparing the return is the husband or wife of the taxpayer. A person who renders mere mechanical assistance

or preparation as, for example, a stenographer or typist, is not considered as preparing the return. If, in the course of his official duties, a deputy collector, an internal revenue agent, or other officer or employee of the Bureau of Internal Revenue actually prepares the return, the person for whom the return is made shall make in the return a brief statement to that effect, and it will not be necessary to make the sworn statement required by this paragraph.

§ 29.51-5 *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a return however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Returns which have not been so prepared will not be accepted as meeting the requirements of the Internal Revenue Code. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time the statement so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form. (See further §§ 29.53-2 to 29.53-4, inclusive.)

§ 29.52-1 *Corporation returns.* Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120. For returns of insurance companies see §§ 29.201-1, 29.204-1 and 29.207-1; of foreign corporations, see section 235; and of affiliated corporations, see section 141 and § 29.141-1. A corporation having an existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets, and it continues in existence. A corporation does not go out of existence if it is merely turned over to receivers or trustees who continue to operate it. A corporation which has received a charter, but has never perfected its organization, which has transacted no business and had no income from any source, may upon presentation of the facts to the collector be relieved from the necessity of making a return as long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. For information returns by corporations contemplating dissolution or liquidation, see section 148 (d). For information returns by corporations of distributions in liquidations, see section 148 (e). For information returns by corporations relating to profits of the taxable year declared as dividends, see section 148 (b). For verification of returns and use of prescribed forms, see §§ 29.51-4 and 29.51-5.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.52-2 *Returns, by receiver.* Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabil-

ities which would devolve upon the officers of the corporation were they in control. (See sections 274 and 298 and §§ 29.274-1 and 29.274-2.) A receiver in charge of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.

§ 29.53-1 *Time for filing returns.* In general, returns of income must be filed on or before the 15th day of the third full calendar month following the close of the taxable year. This rule is subject to several exceptions, in which the time for filing is as follows:

(a) In the case of a return of a nonresident alien individual, at the time prescribed in section 217.

(b) In the case of a return of a nonresident foreign corporation, at the time prescribed in section 235.

(c) In the case of a return for a fractional part of a year beginning in 1942 and ending in 1942, on or before March 15, 1943.

(d) In the case of a final return of a decedent for a fractional part of a year, ending prior to January 1, 1949, on or before March 15 next following the close of the calendar year in which occurred the death of the decedent, except as provided in paragraph (e) of this section.

(e) In the case of a final return for a fractional part of a year ending in 1947 or 1948 of a decedent who, at the moment preceding his death, was on a fiscal year basis and for whom for such year a joint return with his spouse is, on the basis of the facts appearing at the time of the decedent's death, permitted under section 51 (b), on or before the fifteenth day of the third month following the close of the twelve-month period with which such fiscal year would have closed.

(f) In the case of a final return of a decedent for a fractional part of a year ending in 1949 or thereafter, on or before the fifteenth day of the third month following the close of the twelve-month period which began with the first day of such fraction part of the year.

(g) In the case of any return for a fractional part of a year, the Commissioner may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return.

The operation of paragraphs (d) and (e) of this section in cases where joint returns are filed is illustrated by the examples set forth below. In these examples, "H" and "W" are individuals having the status of husband and wife under section 51 (b) (5) and neither (at anytime during the taxable year) is a non-resident alien.

Example (1): H and W make their returns on the calendar year basis. H dies in 1948. Under the rule in paragraph (d), the return of H for his short taxable period ending with the date of his death in 1948 is due on or before March 15, 1949. The return of W for the calendar year 1948 is, under section 53 (a) (1) due on the same date. A joint return for such taxable years of H and W may be made as provided in section 51 (b).

Example (2): H and W make their returns on the basis of a fiscal year ending June 30. H dies on December 1, 1947. Under the facts at the time of the death of H, it would appear that a joint return could be filed under section 51 (b), as amended by the Revenue Act of 1948, for the fractional year of H and the fiscal year of W (ending on June 30, 1948). Accordingly, under the rule in paragraph (e), the return of H for his short taxable period ending December 1, 1947, is due on or before September 15, 1948. The return of W for her fiscal year is, under section 53 (a) (1), due on or before September 15, 1948.

Example (3). The facts in this example are the same as in Example (2), except that H died in January 1948 (instead of on December 1, 1947). In such a case, the due date for the returns of H and W, or their joint return, will be the same as in Example (2).

Example (4). The facts are the same as in Example (2), except that W, the surviving spouse, remarries (or changes her accounting period) in 1948, prior to June 30. For this reason a joint return cannot be made for H and W under section 51 (b). On the basis of the facts existing at the date of the death of H, however, it would appear that under section 51 (b), as amended by the Revenue Act of 1948, a joint return could be filed for H and W for the taxable year of each beginning on July 1, 1947. Accordingly, under the rule in paragraph (e), the time for filing the return of H is on or before September 15, 1948.

A corporation going into liquidation during any taxable year may, upon the completion of such liquidation, prepare a return for that year covering its income for the part of the year during which it was engaged in business and may immediately file such return with the collector. See also section 148 (d) and (e).

For provisions relating to certain cases in which the time for filing income tax returns is postponed by reason of a member (whether or not the taxpayer) of the military or naval forces of the United States serving on sea duty or outside the continental United States, by reason of any other individual (whether or not the taxpayer) being outside the Americas, or by reason of a locality being an area of enemy action or control, see Part 472 of this chapter. See such part also for the circumstances under which the time for filing income tax returns of the spouses of such members or of such other individuals is in certain cases postponed. See such part also as to the time for filing income tax returns of China Trade Act corporations.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5306, 8 F. R. 15816, T. D. 5616, 13 F. R. 2838, T. D. 5662, 13 F. R. 6317]

§ 29.53-2 *Extensions of time for filing returns.* It is important that the taxpayer render on or before the due date a return as nearly complete and final as it is possible for him to prepare. However, the Commissioner is authorized to grant a reasonable extension of time for filing returns under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extensions of time for filing income tax returns is hereby delegated to the various collectors of internal revenue. Application for extensions of time for filing income tax returns should be addressed to the collector of internal revenue for the district in which the taxpayer files his returns and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing income tax returns may be granted for more than six months. For extensions of time for payment of tax, see sections 56 (c) and 272 (j) and §§ 29.53-3, 29.56-2, and 29.272-3.

§ 29.53-3 *Extensions of time in the case of foreign organizations, certain domestic corporations, citizens of United States residing or traveling abroad, and nontaxable returns of fiduciaries for estates or trusts.* (a) An extension of time for filing returns of income for taxable years beginning after December 31, 1941, is hereby granted up to and including the 15th day of the sixth month following the close of the taxable year in the case of:

(1) Foreign partnerships regardless of whether they maintain an office or place of business within the United States;

(2) Foreign corporations which maintain an office or place of business within the United States;

(3) Domestic corporations which transact their business and keep their records and books of account abroad;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States; and

(5) American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States.

In all such cases a statement must be attached to the return showing that the person for whom the return is made is a person described in this subsection. Taxpayers who take advantage of this extension of time will be charged with interest at the rate of 6 percent per annum on the first installment of tax, if any, from the original due date until paid.

(b) An extension of time for filing nontaxable returns of income for taxable years beginning after December 31, 1941, is hereby granted up to and including the 15th day of the fifth month following the close of the taxable year in the case of fiduciaries for estate or trusts. The extension so granted is not applicable to returns of beneficiaries or other distributees of such estates or trusts.

§ 29.53-4 *Due date of return.* The due date is the date on or before which a return is required to be filed in accordance with the provisions of the Internal Revenue Code, including, in the case of certain taxpayers to which section 3804 or 3805 is applicable, the provisions of such section and the regulations prescribed thereunder (see Part 472 of this chapter), or the last day of the period covered by an extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the due date for filing returns will be the day following such Sunday or legal holiday. If placed in the mails, the return should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office

of the collector on or before the due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. If a question may be raised as to whether the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

§ 29.53-5 *Place for filing individual returns.* (a) 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.

(b) An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of section 53 (b) (1), and shall make his return to the 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.

§ 29.54-1 *Records and income tax forms.* Every person subject to the tax, except persons whose gross income (a) consists solely of salary, wages, or similar compensation for personal services rendered, or (b) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1. Every organization exempt from tax under section 101 but required by section 54 (f) to file an annual return shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts, and disbursements, and such other information as is required by § 29.101-2. The books or records required by this section shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

Income-tax forms shall be prescribed by the Commissioner and shall be executed and filed in accordance with this part and the instructions on the form or issued therewith.

The provisions of section 54 (f) relieving certain specified types of organizations exempt from tax under section 101 from filing annual returns do not abridge or impair in any way the powers and authority of the Commissioner provided for in other provisions of the Internal Revenue Code to require the filing of such returns by such organizations. For further regulations regarding proof and establishment of right to exemption from tax, for filing of returns, and keeping records by organizations exempt from tax, see §§ 29.101-1 and 29.101-2.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5381, 9 F. R. 7123]

§ 29.55 (b)-1 *Inspection of returns.* (a) Any properly authorized official, body, or commission, lawfully charged with the administration of any State tax law, or properly designated representatives of such official, body, or commission, may, in the discretion of the Commissioner, inspect income returns for the purpose of such administration. For the purposes of this section the word "returns" shall include information returns, schedules, lists, and other written statements filed with the Commissioner designed to be supplemental to or to become a part of income returns.

(b) Requests for permission to inspect returns must be in writing signed by the governor under the seal of his State, and must be addressed to the Commissioner of Internal Revenue, Records Division, Washington, D. C. The request must state (1) the kind of returns it is desired to inspect, (2) the taxable year or years covered by the returns it is desired to inspect, (3) the name of the official, body or commission by whom or which inspection is to be made, (4) the name of the representative of such official, body, or commission, designated to make the inspection, (5) by specific references, the State tax law which such official, body, or commission is charged with administering and the law under which he, she,

or it is so charged, (6) the purpose for which the inspection is to be made, and (7) if the inspection is for the purpose of obtaining information to be furnished to local taxing authorities, (i) the name of the official, body, or commission of any political subdivision of the State, lawfully charged with the administration of the tax laws of such political subdivision, if any, to whom or to which the information secured by the inspection is to be furnished, and (ii) the purpose for which the information is to be used by such official, body, or commission.

(c) In any case where inspection of the returns is authorized in accordance with the provisions of this section, the Commissioner may, in his discretion, permit inspection of other records and reports which contain information included or required by statute to be included in the return.

(d) For inspection of returns, other than on behalf of States or political subdivisions thereof, and furnishing copies of returns so open to inspection, see §§ 458.50 to 458.71 of this chapter, approved by the President on August 28, 1939, and §§ 458.200 to 458.251 of this chapter, approved September 20, 1939.

§ 29.56-1 *Date on which tax shall be paid.* (a) Except in the case of an individual taxpayer permitted, for taxable years beginning after December 31, 1943, to file his return without showing the tax thereon, the tax unless it is required to be withheld at the source (see section 143, 144, 466, and 1622) or unless it is to be paid by a nonresident alien individual (see section 218) or a foreign corporation not having any office or place of business in the United States (see section 236), is to be paid on or before the 15th day of March following the close of the calendar year, or, if the return is made on the basis of a fiscal year, on or before the 15th day of the third month following the close of such fiscal year. In the case of a return (other than a return by a nonresident alien individual who does not have wages subject to withholding under section 1622, or nonresident foreign corporation) for a fractional part of a year, the tax is to be paid on or before the last day prescribed for the filing of the return (see § 29.53-1). But see § 29.53-3. Except in the case of an individual (other than an estate or trust and other than a nonresident alien individual who does not have wages subject to withholding under section 1622), the tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment either by the Internal Revenue Code or by the Commissioner in accordance with the terms of an extension, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.

(b) In any case in which an individual taxpayer for any taxable year beginning after December 31, 1943, is entitled to elect, and does so elect, to file as his return Form W-2 (Rev.) as provided in § 29.51-2 (b), the amount of the tax determined by the collector shall be paid within 30 days after the date of mailing by the collector to the taxpayer of a notice stating the amount payable by the taxpayer and making demand upon the taxpayer therefor.

(c) In the case of (1) individual citizens and residents of the United States (other than estates and trusts) and (2) nonresident alien individuals who have wages as defined in section 1621 (a) which are subject to withholding under section 1622, the privilege of installment payments of the tax does not apply with respect to taxable years beginning after December 31, 1942.

(d) For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of a member (whether or not the taxpayer) of the military or naval forces of the United States serving on sea duty or outside the continental United States, by reason of any other individual (whether or not the taxpayer) being outside the Americas, or by reason of a locality being an area of enemy action or control, see Part 472 of this chapter. See such part also for the circumstances un-

der which the date otherwise prescribed for the payment of the tax or an installment thereof of the spouses of such members or of such other invididuals is in certain cases postponed. See such part also as to the time for payment of the tax by China Trade Act corporations.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5305, 8 F. R. 15559, T. D. 5425, 10 F. R. 17]

§ 29.56-2 *Extension of time for payment of the tax or installment thereof.* (a) If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner, at the request of the taxpayer, may grant an extension of time for the payment for a period not to exceed six months from the date prescribed for the payment of such amount, part, or installment, except that the extension may be for a period not to exceed five years from the date prescribed for the payment of the tax in the case of such portion of the amount determined as the tax by the taxpayer which is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c)) of a corporation if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in section 115 (c)), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the amount at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

(b) An application for an extension of time for the payment of such tax should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted, subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a tax unless request therefor is made to the collector on or before the date prescribed for payment of the tax or installment thereof for which the extension is desired, or on or before the date or dates prescribed for payment in any prior extension granted.

(c) As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1130 in an amount not exceeding double the amount of the tax or to furnish other security satisfactory to the Commissioner for the payment of the tax, or installment thereof, on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the tax, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax, or installment thereof. (See section 1126 of the Revenue Act of 1926, as amended.) A request by the taxpayer for an extension of time for the payment of one installment does not operate to procure an extension of time for payment of subsequent installments.

Nor does an extension of time for filing a return operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension. If an extension of time for payment of the tax or any installment is granted, the amount, time for payment of which is so extended, shall be paid on or before the expiration of the period of the extension, together with interest at the rate of 6 percent per annum on such amount from the date when the payment should have been made if no extension had been granted until the expiration of the period of the extension. (See section 295.)

§ 29.56–3 *When fractional part of cent may be disregarded.* In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent. Fractional parts of a cent should not be disregarded in the compution of taxes.

§ 29.56–4 *Receipts for tax payments.* Upon request a collector will give a receipt for each tax payment. In the case of payments made by check or money order the canceled check or the money order receipt is usually a sufficient receipt. In the case of payments in cash, however, the taxpayer should in every instance require and the collector should furnish a receipt.

§ 29.57–1 *Examination of return and determination of tax by the Commissioner.* As soon as practicable after returns are filed, they will be examined and the correct amount of the tax determined under such procedure as may be prescribed from time to time by the Commissioner. (See section 272.)

ESTIMATED TAX

§ 29.58–1 *Declarations of estimated tax; taxable year beginning prior to January 1, 1945.* (a) Under the provisions of section 1622 there is withheld at the source a tax designed to approximate the amount of net victory tax, the normal tax, and the first bracket surtax but the tax so withheld applies only to wages and not to other forms of income such as dividends, interest, rents, royalties and the like. In order to collect currently during the taxable year in which the income is received that portion of the tax liability for the taxable year which is not satisfied by collection at the source, there is required to be filed, as specifically set forth in paragraph (b) of this section, for taxable years beginning after December 31, 1942, a declaration of estimated tax for the then current taxable year. As to the contents of such declaration, see section 58 (b). As to the time and place of filing such declaration, see section 58 (d). As to additions to the tax and penalties with respect to filing and contents of declaration, see section 294 (d). As to payment of the estimated tax, see section 59.

(b) A declaration of estimated tax shall, for taxable years beginning after December 31, 1942, and prior to January 1, 1945, be made by (1) every citizen of the United States, whether residing at home or abroad, (2) every individual residing in the United States though not a citizen thereof, and (3) every nonresident alien who is a resident of Canada or Mexico and who has wages subject to withholding at the source under section 1622 if such citizen or resident or alien comes within any of the following groups:

(i) Single or married but not living with spouse at the date prescribed for the making of the declaration (whether or not the head of a family), if such individual had for the preceding taxable year or can reasonably be expected to have for the taxable year:

(*a*) Gross income of more than $2,700 from wages subject to withholding; or

(*b*) Gross income of more than $100 from sources other than wages subject to withholding, and gross income of $500 or more from all sources.

(ii) Married and living with spouse at the date prescribed for the making of the declaration, if such individual had for the preceding taxable year or can reasonably be expected to have for the taxable year:

(*a*) Gross income from wages subject to withholding which, when added to the gross income from such wages of his spouse, exceeds $3,500; or

(*b*) Gross income other than from wages subject to withholding which, when added to the gross income other than from such wages of his spouse, exceeds $100, and his gross income from all sources exceeds $624 for the taxable year or the preceding taxable year (if such preceding taxable year is a taxable year beginning after December 31, 1942), or the aggregate gross income of both spouses from all sources amounts to $1,200 or more for the taxable year or the preceding taxable year.

(iii) Any individual without regard to marital status, (*a*) who was required to file a return under section 51 for the taxable year beginning in 1942 and (*b*) whose gross income from wages for such taxable year is greater than the gross income which can reasonably be expected to be received from wages in the taxable year beginning in 1943. Thus, a married individual making his return on the calendar year basis, who received $3,000 in the form of wages in 1942 and can be reasonably expected to receive $2,000 in the form of wages in 1943 is, under the provisions of paragraph (3) of section 58 (a), required to file a declaration of estimated tax.

(c) For the purposes of determining whether a declaration of estimated tax is required under section 58 (a), a taxpayer who is the head of a family but not married and living with husband or wife is treated as a single person; and for the purpose of determining whether a declaration of estimated tax is required in the case of a husband and wife living together at the time prescribed for filing such declaration, the incomes of such husband and wife for the preceding taxable year shall be aggregated whether or not they were married and living together during any part of such preceding taxable year.

(d) In the case of a husband and wife each having gross income, if their combined gross income meets the requirements of this subsection, a joint declaration of estimated tax must be made by husband and wife or a separate declaration must be made by each.

(e) If an individual had no gross income for the preceding taxable year and it cannot be reasonably expected that he will have gross income for the taxable year, no declaration of estimated tax is required.

(f) A nonresident alien who is a resident of Canada or Mexico, who enters and leaves the United States at frequent intervals and who has wages subject to withholding under the provisions of section 1622, is required to file a declaration of estimated tax if he comes within any of the groups set forth in section 58 (a). In the case of a nonresident alien, gross income means only gross income from sources within the United States, section 212 (a). As to what constitutes gross income from sources within the United States, see section 119 and regulations thereunder. Thus, for example, a nonresident alien living in Canada with his wife throughout 1942 and 1943, makes his return on the calendar year basis. He is employed as a mechanic in Detroit, Michigan, and enters and leaves the United States at frequent intervals. In 1942 he derived an average weekly wage from such source of $80 and had no other income from United States sources. Since his gross income from wages derived from sources within the United States in 1942 amounted to more than $3,500, a declaration of estimated tax must be filed for 1943.

(g) An estate or trust, though taxed generally as an individual, is not within the scope of the system of current payment of the tax and hence is not required to file a declaration.

(h) As used in this section the term "wages" means wages as defined in section 1621.

(i) The application of these provisions may be illustrated by the following examples:

Example (1). A, a taxpayer making his return on the calendar year basis, is unmarried and derived in 1942 wages amounting to $2,500. Effective January 1, 1943, however, his wages were increased to $60 per week and he has been regularly employed at that wage from that date through September 15, 1943, and as at such latter date upon the basis of facts then existing it is reasonable to assume that his wages for the remainder of the calendar year 1943 will remain unchanged. In such case, the wages which can reasonably be expected to be received for 1943 will amount to approximately $3,120 and since such amount exceeds $2,700 A is required to file a declaration of estimated tax.

Example (2). Assume the facts set forth in example (1) except that A's wages for 1942, and as at September 15 the wages reasonably to be anticipated for 1943, do not exceed $2,200 for each of such years but as of such date he could reasonably be expected to receive dividends of $150 for 1943. His total expected gross income being more than $500 and his expected gross income other than wages being more than $100 a declaration of estimated tax must be filed. If, however, his sole income for 1942 and the income reasonably to be expected for 1943 consist of wages of $2,200 for each of such years, no declaration is required since his sole income for each year is less than $2,700, is wholly from wages, and the wages for 1942 are not in excess of the wages reasonably expected to be received for 1943.

Example (3). A, married and living with his wife B throughout 1942 and 1943, makes his return on the calendar year basis. His sole gross income for 1942 and up to Septem-

ber 15, 1943, consists of wages averaging $60 per week. His wife was not employed during 1942 and derived no income during such year but was employed effective July 1, 1943, at $40 per week. Since the wages reasonably to be anticipated by A during 1943 ($3,120) when added to the wages reasonably to be anticipated by B during 1943 ($1,040), aggregate $4,160, and thus exceed the amount of $3,500, a declaration of estimated tax must be filed jointly by A and B or a separate declaration must be made by each.

Example (4). X, married and living with his wife throughout 1943 and making his return on the calendar year basis, has as his only income for 1942 wages of $3,200 and it can be reasonably expected that his only income for 1943 will consist of wages of $2,800. Under the rules laid down above in groups (i) and (ii) X would not be required to file a declaration in 1943. However, X falls within group (iii) since his gross income for 1942 was such as to require the filing of a return for that year and his wages for 1942 are in excess of the wages he can reasonably be expected to receive in 1943.

[Regs. 111, 8 F. R. 14882, as amended by T. D. 5403, 9 F. R. 11053, T. D. 5419, 9 F. R. 14046]

§ 29.58-2 *Declarations of estimated tax; taxable years beginning after December 31, 1944.* (a) A declaration of estimated tax shall, for taxable years beginning after December 31, 1944, be made by every citizen of the United States whether residing at home or abroad, every individual residing in the United States though not a citizen thereof, and every nonresident alien who is a resident of Canada or Mexico and who has wages subject to withholding at the source under section 1622, if such citizen or resident or alien can reasonably be expected to have for such taxable year:

(1) Gross income from wages subject to withholding under section 1622 in excess of the sum of $5,000 plus $500 for each exemption (excluding the exemption claimed for the taxpayer himself) allowable as a credit under section 25 (b); or

(2) Gross income of more than $100 from sources other than wages subject to withholding under section 1622 and total gross income of $500 or more.

(b) In the case of a husband and wife, whether or not they are living together, a joint declaration of estimated tax may be made if the gross income of either spouse meets the requirements of section 58 (a). If the gross income of each spouse meets the requirements of section 58 (a), either a joint declaration must be made or a separate declaration must be made by each. For the purpose of determining whether a declaration of estimated tax is required under the provisions of section 58 (a), a married person may not take into account the exemption of his spouse, if his spouse has, or is reasonably expected to have, gross income.

(c) In estimating his gross income for the taxable year, a parent should not take into account the income of his minor child. Such income is not includible in the gross income of the parent. See section 22 (m).

(d) A nonresident alien who is a resident of Canada or Mexico, who enters and leaves the United States at frequent intervals, and who has wages subject to withholding under the provisions of section 1622 is required to file a declaration of estimated tax if his gross income meets the requirements of section 58 (a). In the case of a nonresident alien gross income means only gross income from sources within the United States. (Section 212 (a).) As to what constitutes gross income from sources within the United States, see section 119 and the regulations thereunder. Thus, for example, a nonresident alien living in Canada with his wife and two dependent children throughout 1945 makes his return on the calendar year basis. His wife and children are also nonresident aliens. He is employed as an executive in Detroit, Michigan, at a salary of $8,000 per annum and enters and leaves the United States at frequent intervals in pursuit of such employment. Neither husband nor wife has any reasonable expectation of any other income from United States sources. Since his wages derived from sources within the United States in 1945 can reasonably be expected to amount to more than $5,000 plus $1,500 ($500 x 3), or $6,500, a declaration of estimated tax must be filed by such resident of Canada for 1945.

(e) An estate or trust though generally taxed as an individual is not within the scope of the system of current payment of the tax, and hence is not required to file a declaration.

(f) The application of these provisions may be illustrated by the following examples:

Example (1). M, a taxpayer making his return on the calendar year basis, is married and has two dependent children. Neither his wife nor children have any source of income. His salary from January 1 to June 30, 1945, was at the annual rate of $6,000.

However, effective July 1, 1945, his annual salary was increased to $8,000 and under the facts then existing it is reasonable to assume that his salary for the remaining portion of 1945 will remain unchanged. As of July 1, 1945, therefore, it is reasonable to expect that he will derive for 1945 a salary of $7,000. Since such amount is in excess of $5,000 plus $1,500 ($500 x 3), or $6,500, M is required to file a declaration of estimated tax for 1945. As to when such declaration is required to be filed, see § 29.58-7 (b).

Example (2). N, a professional man engaged in the practice of his profession on his own account, has gross income of $400 from such profession for the two months of January and February 1945. It can reasonably be expected that he will have no income during 1945 from any other source. Since N has gross income which can for 1945 reasonably be expected to exceed $500 and such income does not constitute wages subject to withholding, he is required to file a declaration of estimated tax regardless of his family or marital status and regardless of the number of surtax exemptions to which he may be entitled for that year.

Example (3). P has been regularly employed for many years prior to January 1, 1945, at which date his weekly wage is $90. He is a widower and has three dependents none of whom has any source of income in 1945. He owns stock in a corporation from which he has derived regularly for many years prior to 1945 annual dividends ranging from $120 to $160. In view of the fact that for 1945 P can reasonably be expected to receive gross income of $500 or more including more than $100 of income from sources other than wages as defined in section 1621 (a), he is required to make a declaration of estimated tax for such year.

Example (4). A is employed at the beginning of 1945 at an annual salary of $8,000 which on the basis of facts then existing, will, it is expected, not undergo any change throughout 1945. It is not reasonably to be anticipated that he will have any other income in 1945. His wife, B, owns stock upon which dividends ranging from $50 to $90 have been paid regularly during years prior to 1945. A and B have four dependent children of whom two have no source of income in 1945; a third child is the beneficiary of a trust fund from which he has received in prior years annual income in the amount of approximately $300, but has no other source of income; while the fourth child is gainfully employed upon a part-time basis and may reasonably be expected to receive compensation for his services amounting to $600 in 1945. Under these facts, for the purpose of determining whether he is required to file a declaration, A may take into account only three surtax exemptions—one for each child expected to receive less than $500 gross income in 1945. Since his anticipated salary of $8,000 exceeds the sum of $5,000 plus $1,500 ($500 x 3), or $6,500, A will be required to file a declaration of estimated tax for 1945. A may not claim a surtax exemption for his wife, B, in his separate declaration since, under the facts assumed, B is expected to have gross income in 1945. If, however, a joint declaration is made, a surtax exemption may be claimed for B.

(g) For the purpose of determining whether the anticipated income for a short taxable year necessitates the filing of a declaration such income shall be placed on an annual basis in the manner prescribed in section 47 (c) (1). Thus, for example, a taxpayer who changes from the calendar year basis to a fiscal year basis beginning July 1, 1945, will have a short taxable year beginning January 1, 1945, and ending June 30, 1945. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 1621 (a) in the amount of $4,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is $8,000, the amount obtained by placing anticipated income of $4,000 upon an annual basis. Hence, assuming such taxpayer is single and has no dependents, he is required to file a declaration for the short taxable year since his anticipated gross income from wages when placed upon an annual basis is in excess of $5,000.

[T. D. 5419, 9 F. R. 14047, as amended by T. D. 5517, 11 F. R. 6532]

§ 29.58-3 *Form and contents of declaration of estimated tax*—(a) *General.* (1) The declaration of estimated tax shall be on Form 1040-ES. The form may be had from the collectors of the several districts. It shall be executed, verified and filed in accordance with these regulations and the instructions on the form or issued therewith. For the purposes of making the declaration, the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, as the case may be, depending upon the method of accounting upon the basis of which the net income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of the estimated tax, shall be determined upon the basis of facts and circumstances existing as at the time prescribed for the filing of the declaration. If, therefore, the taxpayer is employed at the date of filing his declaration at a given wage or salary, it should, in the absence of circumstances indicating the contrary, be presumed by him for

the purposes of the declaration that such employment will continue to the end of the taxable year at the wage or salary received by him as at the date of making the declaration. In the case of the recipient of income other than wages the regularity in the payment of income, such as dividends, interest, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in the X Corporation and dividends have been paid regularly for several years upon such stock, the taxpayer in the preparation of his schedules preliminary to the execution of Form 1040-ES should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the X Corporation for the *taxable year as well as those actually* received in such year prior to the filing of the declaration. In the case of a taxpayer engaged in businee on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(2) In the case of any individual who can, at the time of the preparation of Form 1040-ES, reasonably anticipate that his gross income will be of such amount and character (for the calendar year 1943), or amount (for taxable years beginning after December 31, 1943) as to enable him to elect upon his return for such year to compute the tax under section 400 in lieu of the normal tax and surtax, the declaration of estimated tax may be made upon the basis set forth in section 400 and § 29.400-1. If the taxpayer computes his estimated tax for the calendar year 1943 under the provisions of section 400, it will be necessary for him to add the victory tax to the tax set forth on the reverse side of Form 1040A and appropriate to the taxable income of the taxpayer for the calendar year 1943. Thus, if his gross income is $3,000 and he is a single person not the head of a family, the tax under section 400 is $431. To such amount must be added 5 percent of $2,376 ($3,000 less $624) or $118.80 less the amount of the victory tax credit under section 453. The filing of a declaration computed upon the basis of section 400 shall not constitute an election under section 402 and shall not permit the filing of a return under section 400 unless the taxpayer comes within the provisions of sections 400 and 401. A married person living with husband or wife should not, for the calendar year 1943, use section 400 in computing his estimated tax for the purpose of the declaration unless both spouses use that section for such purpose.

(3) For taxable years beginning after December 31, 1943, section 400 of the Internal Revenue Code, as amended, also may be used in computing the estimated tax for the purposes of the declaration. However, for the purposes of computing the tax liability under chapter 1 for such a taxable year in the case of married persons living together, if the net income of one spouse is determined without regard to the standard deduction, the standard deduction is not allowed to either. Hence, to avoid the risk of underestimating the tax in such case, one spouse should not use section 400 in computing the estimated tax unless the other spouse also uses section 400 or employs the standard deduction in computing the estimated tax.

(4) The declaration may be made by an agent if, by reason of illness, the person liable for the making of the declaration is unable to make it. The declaration may also be made by an agent if the taxpayer is unable to make the declaration by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the declaration. Whenever a declaration is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the income declaration, may submit a certified copy thereof in lieu of the authorization on Form 935. The taxpayer and his agent, if any, are responsible for the declaration as made and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

(5) The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided on the form. A taxpayer having a permanent business address may give that address as the principal or mailing address, provided that the complete home or residential address is also given within the space provided.

(b) *Contents of declaration.* (1) For taxable years beginning in 1943, if the tax for the taxable year beginning in

1942 (after the credit for foreign tax, but before credits for tax paid at source) is greater than the tax for 1943, similarly computed, there shall be included in the estimated tax for 1943 the excess, if any, of the tax for 1942 over the tax for 1943. Such excess is the excess of the tax for 1942 (computed after the credit for the tax, if any, paid at the source under section 143) over the tax for 1943, similarly computed. If, for example, the taxes for 1942 and for 1943, respectively, after the allowance of the credit for foreign tax, if any, are $1,000 and $750 and there is no tax paid at the source under section 143 for either of such years, the increase in the estimated tax for 1943 is $1,000 minus $750, or $250, and thus, the amount to be estimated by the taxpayer as the amount of his income tax (including victory tax) for 1943 for the purpose of the declaration of estimated tax is $1,000, which amount, when reduced by the applicable credits under sections 35 and 466 (e), is the estimated tax for 1943. If, however, in such case tax was paid at the source for the taxpayer under section 143 in the respective amounts, for example, of $100 and $75 for 1942 and 1943 the amount estimated as the amount of the tax for the purpose of the declaration shall be determined as follows: The tax for 1942 after the application of $100 paid at the source is $900 and the tax for 1943 after the application of $75 paid at the source with respect to such year is $675 and in such case the addition to the tax for 1943 is $900 minus $675, or $225, which latter amount when added to $675 aggregates $900, which is the amount of the income tax (including victory tax) for 1943. The excess of such tax ($900) over the amount of the applicable credits under sections 32, 35 and 466 (e) is the estimated tax in such case for 1943.

(2) For taxable years beginning on and after January 1, 1944, the preparation of the declaration of estimated tax will not necessitate any comparison between the tax liability for the current taxable year and that for the preceding taxable year. For such taxable years the declaration shall contain (1) the amount estimated as the tax for the taxable year after the application of the credit for foreign tax, if any, but without regard to the credits under sections 32 and 35; (2) the amount estimated by the taxpayer as the sum of the credits under such sections; and (3) the excess, if any, of the amount shown under (1) over the amount shown under (2), which excess shall be the estimated tax for such taxable year.

[T. D. 5305, 8 F. R. 15554, as amended by T. D. 5403, 9 F. R. 11053; redesignated and amended by T. D. 5419, 9 F. R. 14047]

§ 29.58-4 *Joint declarations by husband and wife.* (a) For taxable years, beginning before January 1, 1944, a husband and wife may make a joint declaration, if they are living together at the time prescribed for filing the declaration. For taxable years beginning after December 31, 1943, a husband and wife may make a joint declaration even though they are not living together. A joint declaration may not be made after the death of either the husband or wife or if either the husband or wife is a nonresident alien.

(b) A joint declaration of a husband and wife, if not made by an agent (see § 29.51-2), shall be signed by both spouses. If signed by one spouse as agent for the other, authorization for such action must accompany the declaration. The spouse acting as agent for the other shall, with the principal, assume the responsibility for making the declaration and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

(c) If a joint declaration is made by husband and wife, the liability with respect to the estimated tax shall be joint and several. The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in any manner they see fit. In any case in which a joint return has been filed by husband and wife for the taxable year beginning in 1942 but separate declarations are made for the taxable year beginning in 1943, the excess, if any, of the joint tax liability for 1942 over the aggregate tax on the separate declarations for 1943, which excess constitutes an addition to the estimated tax for 1943, may be treated as an addition to the estimated tax of either the husband or the wife, or may be divided between them as they may agree.

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See section 6 (b) (1) and (d) (2) of the Current Tax Payment Act of 1943.

(d) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is filed by such spouse. Such separate estimated tax shall be paid at the time and in the amounts determined under the rules prescribed in § 29.58-11. For the purposes of the amended declaration, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree.

[T. D. 5305, 8 F. R. 15554, as amended and redesignated by T. D. 5419, 9 F. R. 14047, 14048]

§ 29.58-5 *Use of prescribed forms.* Copies of the prescribed declaration forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a declaration, however, by the fact that no declaration form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their declarations prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his declaration so as fully and clearly to set forth the data therein called for. If the prescribed form is not available a statement disclosing his estimated income tax (including victory tax for 1943) his estimated credits and his estimated tax after deducting such credits may be accepted as a tentative declaration, and if filed within the prescribed time, accompanied by the payment of the required installment, the statement so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative declaration is supplemented by a declaration made on the proper form.

[T. D. 5305, 8 F. R. 15554, as amended and redesignated by T. D. 5419, 9 F. R. 14048]

§ 29.58-6 *Time and place for filing declarations; years beginning prior to January 1, 1944*—(a) *Time for filing declaration*—(1) *General.* Declarations of estimated tax must (except in the case of farmers as to whom see subparagraph (3) of this paragraph) be made on or before the 15th day of the 3d month of the taxable year by every individual whose then anticipated income for the current taxable year, or whose actual income for the preceding taxable year, meets the requirements of section 58 (a). The requirement with respect to the time for filing the declaration applies alike to nonresident aliens who are required to make the declaration as well as to United States citizens and residents. For the taxable year 1943, in the case of a taxpayer (other than a farmer) who makes his returns on a calendar year basis, the first declaration must be filed on or before September 15, 1943. In the case of such a taxpayer who makes his returns on the fiscal year basis and whose fiscal year begins in 1943 on or prior to July 1, the declaration must likewise be filed on or before September 15, 1943. In the case of such a taxpayer having a fiscal year beginning in 1943 subsequent to July 1, the declaration must be filed on the 15th day of the 3d month of such taxable year. For provisions relating to the time for filing declarations of estimated tax in the case of certain individuals outside the Americas, certain individuals in the military or naval forces of the United States who are serving on sea duty or outside the continental United States, and certain civilian employees of the United States who are prisoners of war or otherwise detained by any foreign government with which the United States is at war, see Part 472 of this chapter.

(2) *Declarations for short taxable years.* No declaration may be made for a period of more than 12 months. A separate declaration for a fractional part of a year is, therefore, required wherever there is a change with the approval of the Commissioner in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate declarations in the several cases are those set forth in section 47 (a). Requirements with respect to filing of a separate declaration for a part of a year are the same as those for the filing of a declaration for a full taxable year commencing at the same time. In the case of a decedent, no declaration need be filed subsequent to the date of death.

In the case of short taxable years ending in 1943, resulting from the change

from the calendar year basis to the fiscal year basis of reporting income, no declaration is required to be filed if such short period ends prior to the date prescribed for the filing of the declaration for the calendar year 1943. If, however, such period ends subsequent to the date prescribed for the filing of the declaration, the declaration must be filed. For example, the taxpayer changes from a calendar year basis to the fiscal year basis beginning July 1, 1943. No declaration for the short period is required since his final return for the period January 1 to June 30 is due on or before September 15, 1943. If, however, he changed to a fiscal year beginning December 1, 1943, a declaration must be filed on or before September 15, 1943 for the period January 1 to November 30, 1943.

(3) *Farmers.* While, generally, the declaration of estimated tax must be filed on or before the 15th day of the third month of the taxable year, the statute provides that in the case of an individual whose estimated gross income from farming for the taxable year is at least 80 percent of his total estimated gross income from all sources for such year there is permitted the election of filing a declaration on or before the 15th day of the last month of the taxable year in lieu of the time prescribed for individuals generally. The estimated gross income from farming is the estimated income resulting from the cultivation of the soil and the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, or orchard. If an individual receives for the use of his land income in the form of a share of the crops produced thereon, such income is from farming. As to determination of income of farmers, see §§ 29.22 (a)–7 and 29.23 (a)–11.

(b) *Place for filing declaration.* (1) The declaration of estimated tax and amendments and revisions thereof shall be filed with the collector for the district in which is located the legal residence or principal place of business of the person making the declaration, or if he has no legal residence or principal place of business in the United States, then with the Collector at Baltimore, Maryland. Any amended declaration shall be filed with the collector for the district in which the original declaration was filed.

(2) An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of this paragraph and shall make his declaration to the 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, Maryland.

(c) *Obligation to file declaration arising after the 15th day of the third month of taxable year.* Generally, the declaration shall be filed on the 15th day of the third month of the taxable year. However, for the calendar year 1943 the 15th day of September 1943 shall be substituted for the 15th day of such third month. If as of the date so prescribed the amount and character of the income of the taxpayer and his marital status are such that no declaration is required to be filed, but subsequent to such date the amount and character of his income or his marital status changes so that he meets the requirements of section 58, then the declaration must be filed not later than the 15th day of the last month of the quarter of the taxable year in which such changes take place.

(d) *Amended declarations.* (1) In the making of a declaration of estimated tax, the statute requires the taxpayer to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, the deductions therefrom and the estimated credits for the taxable year.. Amended or revised declarations may be made in any case in which the taxpayer estimates that his income, deductions, or credits will differ from the income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the marital status of the taxpayer. Such amended declaration shall be on Form 1040–ES, marked "Amended".

(2) No amended or revised declaration may be filed in the quarter in which the original declaration has been field nor in any subsequent quarter in which a prior or revised declaration has been so filed.

[T. D. 5305, 8 F. R. 15554, as amended by T. D. 5419, 9 F. R. 14048]

§ 29.58-7 *Time and place for filing declarations; years beginning after December 31, 1943*—(a) *Special rules applicable to calendar year 1944 and fiscal years beginning in 1944.* (1) The provisions of subsection (a) of section 58, as amended, relating to who shall file a declaration of estimated tax, are applicable only with respect to taxable years beginning after December 31, 1944. The tests, therefore, found in section 58 (a) prior to its amendment by the Individual Income Tax Act of 1944 are applicable to the calendar year 1944 and fiscal years beginning in 1944. In the case of the calendar year 1944 if the requirements therein provided are first met before April 1, 1944, the declaration shall be filed on or before April 15, 1944; if such requirements are first met after March 31, 1944, and before June 2, 1944, the declaration shall be filed on or before June 15, 1944. If, however, such requirements are met on or after June 2, 1944, the general rule provided in section 58 (d) (1) (B) and (C) as amended by the Individual Income Tax Act of 1944 is applicable. Hence, if such requirements are first met after June 1, 1944, and before September 2, 1944, the declaration shall be filed on or before September 15, 1944, and if such requirements are first met after September 1, 1944, the declaration shall be filed on or before January 15, 1945.

(2) In the case of a fiscal year beginning in 1944, the declaration must be filed on the 15th day of the third month of the taxable year. If, however, the requirements of section 58 (a), prior to its amendment, are first met after the first day of the third month and before the second day of the sixth month, the declaration must be filed on or before the 15th day of the sixth month of the taxable year. If such requirements are first met after the first day of the sixth month, and before the second day of the ninth month, the declaration must be filed on or before the 15th day of the ninth month of the taxable year; and if such requirements are first met after the first day of the ninth month, the declaration must be filed on or before the 15th day of the next succeeding taxable year.

(b) *Calendar and fiscal years beginning after December 31, 1944.* (1) Declarations of estimated tax for the calendar year 1945 and subsequent calendar years shall (except in the case of farmers, as to whom see paragraph (c) of this section) be made on or before March 15 of such year by every individual whose then anticipated income for the current calendar year meets the requirements of section 58 (a), as amended. If, however, the requirements necessitating the filing of the declaration are first met, in the case of a taxpayer on the calendar year basis, after March 1, but before June 2 of the calendar year, the declaration must be filed on or before June 15; if the requirements are met after June 1 and before September 2, the declaration must be filed on or before September 15; and if such requirements are first met after September 1, the declaration must be filed on or before January 15 of the succeeding calendar year. In the case of a taxpayer on the fiscal year basis, the declaration must be filed on the 15th day of the third month of the taxable year. If, however, the requirements of section 58 (a), as amended, are first met after the first day of the third month and before the second day of the sixth month, the declaration must be filed on or before the 15th day of the sixth month of the taxable year. If such requirements are first met after the first day of the sixth month, and before the second day of the ninth month, the declaration must be filed on or before the 15th day of the ninth month, of the taxable year, or if such requirements are met after the first day of the ninth month, the declaration must be filed on or before the 15th day of the next succeeding fiscal year. Thus, if an individual taxpayer is on the fiscal year basis ending June 30, 1946, his declaration must be filed on or before September 15, 1945, if the requirements of section 58 (a) are met on or before September 1, 1945. If, however, such conditions are not met until after September 1, 1945, and before December 2, 1945, the declaration need not be filed until December 15, 1945.

(2) For calendar and fiscal years beginning after December 31, 1944, the requirements with respect to the filing of the declaration are those prescribed in section 58 (a), as amended. The requirements with respect to the time for filing the declaration apply alike to such nonresident aliens as are required to make a declaration as well as to United States citizens and residents. In the case of certain individuals outside the Americas, certain individuals in the military or naval forces of the United States who are serving on sea duty or outside the continental United States, and certain civil-

ian employees of the United States who are prisoners of war or otherwise detained by any foreign government with which the United States is at war, the provisions of Treasury Decision 5279 (set forth in paragraph 111a of the Appendix to these regulations) relative to the time for filing returns are also applicable with respect to the time for filing declarations. In the case of any such individual, however, if the time for filing the return for a taxable year is postponed under the provisions of Treasury Decision 5279, a declaration of estimated tax for such taxable year is not required.

(c) *Farmers.* In the case of an individual, whose estimated gross income from farming for the taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day of January of the succeeding taxable year in lieu of the time prescribed for individuals generally. The provisions of § 29.58-6 (a) (3) relating to what constitutes farming are equally applicable to taxable years beginning after December 31, 1943.

(d) *Declarations for short taxable years.* (1) No declaration may be made for a period of more than 12 months. A separate declaration for a fractional part of a year is, therefore, required where there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate declarations in the several cases are those set forth in section 47 (a). No declaration, however, is required for a taxable year of less than three months. In the case of a decedent, no declaration need be filed subsequent to the date of death. As to requirement for amended declaration if death of one spouse occurs after filing a joint declaration, see § 29.58-4.

(2) In the case of short taxable years the declaration shall be filed on or before the 15th day of the third month of such taxable year if the requirements of section 58 (a) are met on or before the first day of the third month of such year. If such requirements are first met after the first day of the third month but before the second day of the sixth month, the declaration must be filed on or before the 15th day of the sixth month. If, however, the period for which the declaration is filed is one of three months, or one of six months and the requirements of section 58 (a) were not met until after the first day of the third month, or one of nine months and such requirements were not met until after the first day of the sixth month, the declaration may be filed on or before the 15th day of the succeeding taxable year. If the short taxable year is a period:

(i) Of at least three months but less than six months and the requirements of section 58 (a) are first met after the first day of the third month, or

(ii) Of at least six months but less than nine months and the requirements of section 58 (a) are first met after the first day of the sixth month, or

(iii) Of nine months or more and the requirements of section 58 (a) are first met after the first day of the ninth month,

no declaration is required.

(3) In the case of an individual whose estimated gross income from farming for a short taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the fifteenth day of the month immediately following the close of such taxable year.

(e) *Place for filing declarations.* The rules prescribed in § 29.58-6 (b) with respect to the place for filing the declaration are equally applicable to taxable years beginning after December 31, 1943.

(f) *Amended declarations.* In the making of a declaration of estimated tax, the statute requires the taxpayer to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of surtax exemptions to which the taxpayer may be entitled for the then current taxable year, such as the acquisition of a dependent or divorce or marriage of the taxpayer. Such amended declaration shall be on Form 1040ES, marked "Amended". No amended or revised declaration may be filed in the quarter in which the original declaration has been filed nor in any subsequent quarter in which a prior or

revised declaration has been filed. For taxable years beginning after December 31, 1943, where an original declaration has previously been filed: In the case of a taxpayer on the calendar year basis, an amended declaration filed after September 15 may be filed on or before January 15 of the succeeding calendar year; in the case of a taxpayer on the fiscal year basis, an amended declaration filed after the 15th day of the ninth month of such fiscal year may be filed on or before the 15th day of the succeeding fiscal year. Thus, if a taxpayer is on a fiscal year basis beginning July 1, 1944, an amended declaration filed after March 15, 1945, may be filed on or before July 15, 1945.

(g) *Return as a declaration of estimated tax or amendment thereof.* (1) If the taxpayer files his return for the calendar year on or before January 15 of the succeding calendar year (or if the taxpayer is on a fiscal year basis, on or before the 15th day of the first month immediately succeeding the close of such fiscal year) and pays in full the amount of tax shown by such return as payable, then:

(i) Such return shall be considered also as a declaration for such taxable year if, in such case, the taxpayer first met the requirements of section 58 (a) (relating to the requirements with respect to filing of declarations) after September 1 of the taxable year (or the first day of the ninth month of the taxable year if the taxpayer is on a fiscal year basis); and

(ii) If the tax shown on such return differs from the estimated tax shown in the previously filed declaration, such return shall be considered as an amended declaration the filing of which prior to January 15 of the succeeding taxable year is permitted by section 58 (d) (2).

(2) Hence, for example, an individual taxpayer on the calendar year basis who, subsequent to September 1, 1944, first meets the requirements of section 58 (a) (prior to amendment by the Individual Income Tax Act of 1944) which necessitate the filing of such declaration in 1944, may satisfy the requirements as to the filing of such declaration by filing his return for 1944 on or before January 15, 1945, and paying in full at the time of such filing the tax shown thereon to be payable. A taxpayer on the fiscal year basis, who first meets the requirements of section 58 (a) after the first day of the ninth month of such taxable year, may satisfy the requirements as to the filing of such declaration by filing his return and paying the tax on or before the fifteenth day of the first month following the close of such fiscal year.

(3) Likewise, if a taxpayer files on or before September 15 a timely declaration for such year and subsequent thereto and on or before January 15 of the succeeding taxable year (or corresponding date in the case of a taxpayer on the fiscal year basis) files his return for such year, and pays at the time of filing the tax shown by the return to be payable, such return shall be treated as an amended declaration timely filed.

(4) For the purposes of section 59 (d) (3) a taxpayer may file his return, Form 1040, on or before the 15th day of the first month following the close of the taxable year even though he has not been furnished by his employer Form W-2 or Form W-2 (Rev.). In such case the taxpayer shall compute, as accurately as possible, his wages for such year and the tax withheld for which he is entitled to a credit, reporting such wages and tax on his return, Form 1040, together with all other pertinent information necessary to the determination of his tax liability for such year.

[T. D. 5419, 9 F. R. 14048]

§ 29.58-8 *Extension of time for filing declarations.* (a) It is important that the taxpayer render on or before the due date a declaration of estimated tax as accurate as the facts and circumstances then existing or reasonably to be anticipated permit. However, the Commissioner is authorized to grant a reasonable extension of time for filing declarations under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extension of time for filing declarations is hereby delegated to the various collectors of internal revenue. Applications for extensions of time for filing declarations shall be addressed to the collector of internal revenue for the district in which the taxpayer files his income tax returns, and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing declarations may be granted for more than six months.

(b) An extension of time for filing the declaration of estimated tax for taxable years beginning on or before July 1, 1943, is hereby granted to and including the

15th day of December 1943, in the case of United States citizens outside the States of the Union, the District of Columbia, and Hawaii on September 15, 1943; and for taxable years beginning after July 1, 1943, an extension of time for filing the declaration of estimated tax otherwise due on or before the 15th day of the third month of the taxable year is hereby granted to and including the 15th day of the sixth month of the taxable year in the case of United States citizens outside the States of the Union, the District of Columbia, and Hawaii on the 15th day of the third month of the taxable year.

(c) An extension of time for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period.

[T. D. 5305, 8 F. R. 15554. Redesignated by T. D. 5419, 9 F. R. 14049]

§ 29.58-9 *Publicity of returns.* The declaration of estimated tax constitutes, within the meaning of section 55, a return. Hence, the rules provided under that section with respect to publicity of returns are equally applicable to declarations of estimated tax. See section 55 and regulations thereunder.

[T. D. 5305, 8 F. R. 15554. Redesignated by T. D. 5419, 9 F. R. 14049]

§ 29.58-10 *Payment of estimated tax; years beginning prior to January 1, 1944*—(a) *General.* (1) Section 59 provides that if the declaration of the estimated tax is made on or before the 15th day of the third month of the taxable year, such tax may be paid at the time of filing the declaration or in four equal installments. In such case the first installment shall be paid at the time of filing the declaration, the second installment on or before the 15th day of the sixth month, the third installment on or before the 15th day of the ninth month and the fourth installment on or before the 15th day of the 12th month of the taxable year.

(2) If the declaration of estimated tax is filed after the 15th day of the third month of the taxable year (otherwise than by reason of an extension of time), the estimated tax shall be paid at the time of filing the declaration or in equal installments the number of which is equal to the number of quarters remaining in the taxable year (including the quarter in which the declaration is filed). Thus, since the first declaration of estimated tax for the calendar year 1943 is required to be filed on or before September 15 of that year, the estimated tax for such year must be paid at the time of filing the declaration or in two equal installments, one on or before September 15, and the other on or before December 15, of that year. For the fiscal year beginning June 1, 1943, and ending May 31, 1944, the declaration is required to be filed on or before September 15, 1943, and one-third of the estimated tax shown on such declaration shall be paid on or before September 15, 1943, one-third on or before February 15, 1944, and one-third on or before May 15, 1944, unless the taxpayer elects to pay two or more installments of the estimated tax at the time of filing the declaration.

(3) If the taxpayer files an amended or revised declaration of estimated tax, the installments remaining unpaid as of the date of such filing shall be ratably increased or decreased, as the case may be, to reflect any change made in the previously estimated tax by such amendment or revision.

(4) At the election of the taxpayer, any installment of the estimated tax may be paid prior to the date prescribed for the payment.

(5) The payment of any and every installment of the estimated tax for any taxable year shall be treated as a payment on account of the income tax for such taxable year. Hence, upon the return, Form 1040, or Form 1040A, as the case may be, for such taxable year will appear as payments to be applied against the tax shown on such return the aggregate amount of the payments of estimated tax.

(6) The regulations generally applicable to extensions of the time for the payment of the tax or any installment thereof are likewise applicable to extensions of time for the payment of estimated tax, except that extensions of time for payment of the estimated tax or any installment thereof shall be without interest. See § 29.56-2.

(b) *Farmers.* In the case of an individual whose estimated gross income from farming is at least 80 percent of his total gross income from all sources for the taxable year, special provisions are made with respect to the filing of the declaration, the payment of the tax and the penalties incurred. As to what constitutes income from farming within the meaning of this paragraph, see

§ 29.58-6 (a) (3). In such case the declaration is to be filed on or before the 15th day of the last month of the taxable year, and the entire amount of the estimated tax must be paid at that time.

(c) *Treatment of payments on account of 1942 tax.* (1) In the case of a taxable year beginning in 1942, the liability for the tax for such taxable year 1942 is discharged as of September 1, 1943. However, any payments (other than interest and additions to the tax) made before September 1, 1943 on account of the 1942 tax are treated as payments on account of the estimated tax for the taxable year beginning in 1943. Taxpayers on the calendar year basis who elected to pay their 1942 tax in installments were required to pay one of such installments on March 15, 1943, and another on June 15, 1943. Such installments are treated as payments on account of the estimated tax for the taxable year 1943. In any case in which the payment of any of such installments due prior to September 1, 1943, is extended by the Commissioner prior to that date, such payment is likewise treated as a payment of estimated tax for 1943 and is required to be paid despite the fact that the provisions discharging the tax liability for 1942 are effective as of September 1, 1943. If the taxpayer should become delinquent prior to September 1, 1943, in the payment of his tax or any installment thereof, the fact that the liability for the tax for 1942 is discharged as of that date does not relieve the taxpayer of his liability for payment of such installment. Such payment when made, however, is to be treated as a payment made on account of the estimated tax for 1943.

(2) The amounts so treated as payment on account of the estimated tax for 1943 shall be applied against the estimated tax of the taxpayer for the taxable year 1943 as shown in his declaration of estimated tax for that year and shall thus reduce ratably the installments of the estimated tax shown thereon. Thus, if the estimated tax for 1943 is $1,000 and the taxpayer being on the calendar year basis has paid two installments of 1942 tax liability each amounting to $200, the estimated tax after the application of such payments is reduced to $600 of which one-half is to be paid at the time of filing the declaration, namely, on or before September 15, 1943, and the remaining installment on or before December 15, 1943.

(3) If, in the case of husband and wife, a joint return has been filed for the taxable year beginning in 1942, any payment due prior to September 1, 1943, made with respect to the tax liability shown thereon may, if separate declarations are made by the spouses for the taxable year beginning in 1943, be applied against the estimated tax of either spouse or may be divided between them in any manner they see fit. In any case in which a joint return has been filed by husband and wife for the taxable year beginning in 1942 but separate declarations are made for the taxable year beginning in 1943, the excess, if any, of the joint tax liability for 1942 over the aggregate tax on the separate declarations for 1943, which excess constitutes a part of the estimated tax for 1943, may be treated as a part of the estimated tax of either the husband or the wife, or may be divided between them as they see fit.

[T. D. 5305, 8 F. R. 15554. Redesignated and amended by T. D. 5419, 9 F. R. 14049]

§ 29.58-11 *Payment of estimated tax; years beginning after December 31, 1943*—(a) *General.* (1) Section 59 (a), as amended, provides the following rules governing the time for payment of the estimated tax for calendar years beginning after December 31, 1943:

Date of Filing Declaration	*Dates of Payment of Estimated Tax*
I. On or before March 15 (for calendar year 1944, April 15).	In four equal installments—one at time of filing declaration, one not later than June 15, one not later than September 15, and one not later than January 15 of the succeeding taxable year.
II. After March 15 and before June 16 and not required to be filed on or before March 15.	In three equal installments—one at time of filing declaration, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
III. After June 15 and before September 16 and not required to be filed on or before June 15.	In two equal installments—one at time of filing declaration, and the other on or before January 15 of the succeeding taxable year.
IV. After September 15 and not required to be filed on or before that date.	In full at time of filing declaration.

(2) If, for example, due to the nature and amount of his gross income and his then existing marital status for 1945, the taxpayer is not required to file his declaration as of March 15, but is required to file on or before June 15, 1945, the case comes within the scope of class II in subparagraph (1) of this paragraph and the estimated tax is payable in full at the time of filing the declaration or, in the alternative, in three equal installments, one on the date of filing, one on or before September 15, 1945, and the third installment on or before January 15, 1946.

(3) Notwithstanding the rules set forth above relating to the time for payment of the estimated tax, section 59 provides that if in any case a declaration is filed after the time prescribed in section 58 (d) (including a case in which such filing is due to an extension of time granted for filing the declaration) the estimated tax shall be paid at the time of filing the declaration or, in the alternative, there shall be paid at such time all installments of the estimated tax which would have been payable on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 58 (d), and the remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been so filed. Thus, for example, A, a married man who makes his return on the calendar year basis, was employed from the beginning of 1944 and for several years prior thereto at an annual salary of $5,000, thus meeting the requirements of section 58 (a) prior to its amendment by the Individual Income Tax Act of 1944. A filed his declaration for 1944 on September 16, 1944. In such case, A should have filed a declaration on or before April 15, 1944, and at the time of filing his declaration he was delinquent in the payment of three installments of his estimated tax for the taxable year 1944. Hence, upon his filing the declaration on September 16, 1944, three-fourths of the estimated tax shown thereon must be paid.

(4) In the case of a taxpayer on the fiscal year basis, there shall be substituted for the dates March 15, June 15, September 15 and January 15 of the succeeding taxable year, the 15th day of the third month, the 15th day of the sixth month and the 15th day of the ninth month of the taxable year and the 15th day of the succeeding taxable year, respectively. For example, if a taxpayer on the fiscal year basis ending June 30, 1945, first meets on January 15, 1945, the requirements of section 58 (a) without regard to its amendment by the Individual Income Tax Act of 1944, and the declaration is filed on or before March 15, 1945, the estimated tax shall be paid in two equal installments, one at the time of filing such declaration and the second on or before July 15, 1945.

(5) In the case of a decedent, payments of estimated tax are not required subsequent to the date of death. See, however, § 29.58-4 for requirement of amended declaration by surviving spouse if a joint declaration was made with decedent before death.

(6) At the election of the taxpayer any installment of the estimated tax may be paid prior to the date prescribed for its payment.

(7) The payment of any and every installment of the estimated tax for any taxable year beginning after December 31, 1943, shall be considered payment on account of the tax for such taxable year. Hence, upon the return for such taxable year, the aggregate amount of the payments of estimated tax should be entered as payments to be applied against the tax shown on such return.

(b) *Farmers.* In the case of an individual whose estimated gross income from farming for taxable years beginning after December 31, 1943, is at least two-thirds of his total gross income from all sources for such taxable year, special provisions are made with respect to the filing of the declaration, the payment of the tax, and the penalties incurred. As to what constitutes income from farming within the meaning of this subsection, see § 29.58-6 (a) (3). In such case, if such taxable year is the calendar year, the declaration is to be filed on or before January 15 of the succeeding calendar year and payment of the estimated tax shall be made in full at such time. In the case of a farmer on the fiscal year basis, the declaration may be filed on or before the 15th day of the succeeding fiscal year and payment of the estimated tax shall be made in full at such time.

(c) *Special rules for 1944.* In any case in which a declaration of estimated tax for the calendar year 1944 is filed on or before April 15, 1944, the estimated

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tax shall be paid at the time of the filing of the declaration or, in the alternative, in four equal installments as follows: the first installment to be paid at the time of filing the declaration; the second installment on or before June 15; the third installment on or before September 15; and the fourth installment on or before January 15, 1945. If the declaration is filed after April 15, 1944, but before June 16, 1944, and such requirements of section 58 (a) were first met on or after April 1, 1944, the estimated tax may be paid in three equal installments as follows: the first installment at the time of filing the declaration, the second on or before September 15, 1944, and the third installment on or before January 15, 1945. If, however, the requirements of section 58 (a) (without regard to the amendment made by the Individual Income Tax Act of 1944) were first met before April 1, 1944, but no declaration was filed until after April 15, 1944, or if such requirements were met after March 31, 1944, and before June 2, 1944, and no declaration was filed until after June 15, 1944, then there shall be paid at the date of filing such declaration all installments of estimated tax which would have been payable on or before such date if the declaration had been filed within the time prescribed and the remaining installments shall be paid at the times at which and in the amounts in which they would have been payable had the declaration been so filed.

(d) *Short taxable years.* (1) In the case of a short taxable year for which a declaration is required to be filed the estimated tax shall be paid in equal installments, one at the time of filing the declaration, one on the 15th day of the third month of each succeeding three-month period contained in such short taxable year except the last such three-month period or fraction thereof, and one on the 15th day of the first month of the succeeding taxable year. For example, if the short taxable year is the period of 10 months from January 1, 1945, to October 31, 1945, and the declaration is required to be filed on or before March 15, 1945, the estimated tax is payable in four equal installments, on the date of filing the declaration, June 15, September 15, and November 15. If in such case the declaration is required to be filed after March 15 but on or before June 15, the tax will be payable in three equal installments, on the date of filing the declaration, September 15 and November 15.

(2) The provisions of paragraph (a) of this section relating to payment of estimated tax in any case in which the declaration is filed after the time prescribed in section 58 (d) are equally applicable to the payment of the estimated tax for short taxable years.

[T. D. 5419, 9 F. R. 14049]

SUBPART C—SUPPLEMENTAL PROVISIONS

AUTHORITY: §§ 29.101-1 to 29.421-1 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 29.101-1 to 29.421-1 contained in Regulations 111, 8 F. R. 15002, except as noted following sections affected.

RATES OF TAX

§ 29.101-1 *Proof of exemption prior to January 1, 1943; annual returns for accounting periods beginning prior to January 1, 1943.* A corporation is not exempt merely because it is not organized and operated for profit. In order to establish its exemption it is necessary that every organization claiming exemption file with the collector for the district in which is located the principal place of business or principal office of the organization an affidavit or a questionnaire as set forth below. An organization claiming exemption under section 101 (1), (3), (4), except a bona fide credit union, (6) (7), (8), (9), (10), (12), (14), or (16) shall file the form of questionnaire appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following questionnaire forms may be obtained from any collector: For corporations claiming exemption under section 101 (6), Form 1023; under section 101 (1), (3), (7), or (8), Form 1024; under section 101 (9), Form 1025; under section 101 (10), (14), or (16), Form 1026; under section 101 (4), except bona fide credit unions, Form 1027; and under section 101 (12), Form 1028. All other organizations claiming exemption, including bona fide credit unions, shall file an affidavit showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To each such affidavit or questionnaire shall be attached a copy of the articles of incorporation, declaration of trust, or other

instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization. An organization claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14) shall also file with the other information specified herein a return of information on Form 990 relative to the business of the organization for the last complete year of operation: *Provided, however,* That such return shall not be required of an organization which is organized and operated exclusively for educational purposes, or educational and religious purposes, if no part of its net earnings or assets are distributable to any private shareholder in liquidation or otherwise and if, in the case of an organization privately owned or operated, the Commissioner is advised of any increase in the compensation of its owners, managers, trustees, or directors over the amount of such compensation for the last year for which its exemption under section 101 (6) was approved by the Commissioner. Form 990 will not be required of charitable organizations operated or controlled by religious or educational organizations of the type exempt under the preceding sentence from the requirement of filing such returns, nor of separately conducted charitable organizations meeting the above conditions as to distributions and compensation, nor of charitable organizations operated under the control of a State or any political subdivision thereof.

The words "private shareholder or individual" in section 101 refer to individuals having a personal and private interest in the activities of the corporation. Although religious or apostolic associations or corporations exempt under section 101 (18) are relieved from paying the tax, they are required to file returns of income (see § 29.101 (18)-1).

In the case of the particular classes of organizations listed below, the following additional information shall be embodied in or attached to, and made a part of, the affidavit or questionnaire referred to above:

(a) Mutual insurance companies shall submit copies of the policies or certificates of membership;

(b) In the case of holding companies claiming exemption under section 101 (14), if the organization for which title is held has not been specifically notified in writing by the Bureau of Internal Revenue that it is held to be exempt under section 101, the holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

The collector, upon receipt of the affidavit, or questionnaire, and other papers, will examine them as to completeness and will forward completed documents to the Commissioner for decision as to whether the organization is exempt. In addition to the information specified herein, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 101, and when deemed advisable in the interest of an efficient administration of the internal revenue laws he may in the cases of particular types of organizations provide additional questionnaires or otherwise prescribe the form in which the proof of exemption shall be furnished.

When an organization (other than a mutual insurance company) has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created, except that every organization exempt or claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7) (8), (9), or (14) shall file annually returns of information on Form 990 with the collector for the district in which is located the principal place of business or principal office of the organization: *Provided, however,* That such return shall not be required of an organization which is organized and operated exclusively for educational purposes, or educational and religious purposes, if no part of its net earnings or assets are distributable to any private shareholder in liquidation or otherwise and if, in the case of an organization privately owned or operated, the Commissioner is advised of any increase in the compensation of its owners, managers, trustees, or directors over the amount of such compensation for the last year for which its exemption

under section 101 (6) was approved by the Commissioner. Form 990 will not be required of charitable organizations operated or controlled by religious or educational organizations of the type exempt under the preceding sentence from the requirement of filing such returns, nor of separately conducted charitable organizations meeting the above conditions as to distributions and compensation, nor of charitable organizations operated under the control of a State or any political subdivision thereof. The return of information on Form 990 shall be filed on or before the 15th day of the fifth month following the close of the taxable year. When a mutual insurance company has established its right to exemption under section 101 (11) of the Internal Revenue Code or a corresponding provision of a prior income tax law it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or unless the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) exceeds $75,000. See § 29.101 (18)-1 with respect to returns by religious or apostolic associations or corporations exempt under section 101 (18). See also sections 275 (a) and 276 (a) with respect to the statute of limitations.

Collectors will keep a list of all organizations held to be exempt to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.

An organization which is exempt under section 101 and the regulations thereunder, from filing returns of income is not, however, relieved from the duty of filing returns of information (see sections 147 and 148).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5381, 9 F. R. 7123]

§ 29.101 (1)-1 *Labor, agricultural, and horticultural organizations.* (a) The organizations contemplated by section 101 (1) as entitled to exemption from income taxation are those which:

(1) Have no net income inuring to the benefit of any member;

(2) Are educational or instructive in character; and

(3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b) Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations which have for their purpose, for example, the holding of periodical race meets, the profits from which may inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

§ 29.101 (2)-1 *Mutual savings banks.* In order that a corporation may be entitled to exemption as a mutual savings bank, it must appear that it is an organization:

(a) Which has no capital stock represented by shares, and

(b) Whose earnings, less only the expenses of operation, are distributable wholly among the depositors.

If it appears that the organization has shareholders who participate in the profits, the organization will not be exempt.

A mutual savings bank need not be incorporated or be under public supervision, unless, in either case a State statute so requires, nor need it serve the public in general, in order to be exempt. It may confine its business to a designated class of individuals, such as employees of a single corporation, without losing its exempt status.

§ 29.101 (3)-1 *Fraternal beneficiary societies.* A fraternal beneficiary society is exempt from tax only if operated under the "lodge system," or for the exclusive benefit of the members of a society so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

§ 29.101 (4)-1 *Building and loan associations and cooperative banks.* (a) A building and loan association organized pursuant to and operating in accordance with the laws of the United States or a State or Territory thereof, substantially all the business of which association is confined to making loans to members, is entitled to exemption.

(b) 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.

§ 29.101 (5)-1 *Cemetery companies.* (a) A cemetery company may be entitled to exemption:

(1) If it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for purpose of resale, or

(2) If it is not operated for profit.

(b) Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual. A cemetery company which fulfills the other requirements of the Internal Revenue Code may be exempt, even though it issues preferred stock entitling the holders to dividends at a fixed rate, not exceeding the legal rate of interest in the State of incorporation, or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, provided that its articles of incorporation require:

(1) That the preferred stock shall be retired at par as soon as sufficient funds available therefor are realized from sales, and

(2) That all funds not required for the payment of dividends upon or for the retirement of preferred stock shall be used by the company for the care and improvement of the cemetery property.

§ 29.101 (6)-1 *Religious, charitable, scientific, literary, and educational organizations and community chests.* (a) In order to be exempt under section 101 (6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

(b) Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

(c) An educational organization within the meaning of the Internal Revenue Code is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association of either class has incidental amusement features. An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Code. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

(d) Since a corporation to be exempt under section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit, is not exempt under section 101 (6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. See section 101 (18) as to religious or apostolic associations or corporations.

(e) A corporation otherwise exempt under section 101 (6) does not lose its status as an exempt corporation by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.

§ 29.101 (7)-1 *Business leagues, chambers of commerce, real estate boards, and boards of trade.* A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of the Internal Revenue Code and is not exempt from tax.

§ 29.101 (8)-1 *Civic leagues and local associations of employees.* Civic leagues entitled to exemption under section 101 (8) comprise those not organized for profit but operated exclusively for purposes beneficial to the community as a whole, and, in general, include organizations engaged in promoting the welfare of mankind, other than organizations comprehended within section 101 (6). Certain local associations of employees are also expressly entitled to exemption under section 101 (8). The Internal Revenue Code prescribes as conditions to exemption (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. See § 29.101 (6)-1 with reference to the meaning of "charitable" and "educational" and § 29.101 (10)-1 as to the meaning of "local" as used in section 101.

[Regs. 111, 8 F. R. 15002 as amended by T. D. 5458, 10 F. R. 7335]

§ 29.101 (9)-1 *Social clubs.* The exemption granted by section 101 (9) applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club engages in traffic, in agriculture or horticulture, or in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. Generally, an incidental sale of property will not deprive the club of the exemption.

§ 29.101 (10)-1 *Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.* It is a prerequisite to exemption under section 101 (10) that at least 85 percent of the income of the organization shall consist of amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 101 (10). It applies, however, to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the bor-

ders of a State, it cannot be considered to be purely local in character.

§ 29.101 (11)-1 *Mutual insurance companies or associations.* An insurance company is exempt from taxation under this chapter if it is a mutual company or association (other than life or marine) or an interinsurer or reciprocal underwriter and if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.101 (12)-1 *Farmers' cooperative marketing and purchasing associations.* (a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Internal Revenue Code and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an afficer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond

the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) of this section relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either paragraph (a) or (b) of this section an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a) of this section. An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Internal Revenue Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101 (12) and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101 (12).

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, such as marketing building materials, are not exempt.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.101 (13)-1 *Corporations organized to finance crop operations.* Corporations organized by farmers' cooperative marketing or purchasing associations, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers are also exempt, provided the marketing or purchasing association is exempt under section 101 (12), and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of § 29.101 (12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§ 29.101 (18)-1 *Religious or apostolic associations or corporations.* Religious or apostolic associations or corporations are exempt from taxation under chapter 1 if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members include (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101 (18) and this section shall make for each taxable year a return on Form 1065 (except for taxable years beginning before January 1, 1947, with respect to which return were made on Form 1120) 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.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335, T. D. 5600, 13 F. R. 577]

§ 29.101-2 *Proof of exemption on or after January 1, 1943; annual returns for accounting periods beginning on or after January 1, 1943*—(a) *Proof of exemption.* An organization is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption it is necessary that every organization claiming exemption file with the collector for the district in which is located the principal place of business or principal office of the organization an affidavit or questionnaire as set forth below. An organization claiming exemption under section 101 (1), (3), (4), except a bona fide credit union, (6), (7), (8), (9), (10), (12), (14), or (16) shall file the form of affidavit or questionnaire appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following forms may be obtained from any collector: For organizations claiming exemption under section 101 (6), Form 1023; under section 101 (1), (3), (7), or (8), Form 1024; under section 101 (9), Form 1025; under section 101 (10), (14), or (16), Form 1026; under section 101 (4), except bona fide credit unions, Form 1027; and under section 101 (12), Form 1028. All other organizations claiming exemption, including bona fide credit unions, shall file an affidavit showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To each such affidavit or questionnaire shall be attached a copy of the articles of incorporation, declaration of trust, or other instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization.

(b) *Additional proof by particular classes of organizations.* Organizations mentioned below shall submit with and as a part of their affidavits or questionnaires the following information:

(1) Mutual insurance companies shall submit copies of the policies or certificates of membership;

(2) In the case of holding companies claiming exemption under section 101 (14), if the organization for which title is held has not been specifically notified in writing by the Bureau of Internal Revenue that it is held to be exempt under section 101, the holding company shall submit the information indicated in this section as necessary for a determination of the status of the organization for which title is held.

In addition to the information specifically called for by this section the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 101, and when deemed advisable in the interest of an efficient administration of the internal revenue laws he may in the cases of particular types of organizations provide additional questionnaires or otherwise prescribe the form in which the proof of exemption shall be furnished.

An organization claiming to be specifically exempted by section 54 (f) from filing annual returns shall submit with and as a part of its affidavit or questionnaire a statement of all the facts on which it bases its claim.

(c) *Collector's duties with respect to proof of exemption.* The collector, upon receipt of the affidavit or questionnaire and other papers constituting the proof of exemption by an organization claiming exemption from tax under section 101, will forward completed documents to the Commissioner for decision as to whether the organization is exempt.

(d) *"Private shareholder or individual" defined.* The words "private shareholder

or individual" in section 101 refer to persons having a personal and private interest in the activities of the organization.

(e) *Requirement of annual returns.* For accounting periods beginning after December 31, 1942, every organization exempt from tax under section 101, regardless of the amount or source of its income or receipts and irrespective of whether it is chartered by, or affiliated or associated with, any central, parent, or other organization, except organizations specifically exempted from filing annual returns by section 54 (f) (see paragraph (h) of this section), shall file annually with the collector for the district in which is located the principal place of business or principal office of the organization a return of information on Form 990 (Revised May 1944) specifically stating the items of gross income, receipts, and disbursements and such other information as may be prescribed by the Commissioner in the instructions on the form or issued by him therewith. Such return shall be on the basis of the established annual accounting period of the organization. Where the organization has no such established accounting period, the return shall be on the basis of the calendar year. Religious and apostolic organizations which are exempt from tax under section 101 (18) shall annually file the return of income required under § 29.101 (18)-1 on the same form (Form 1065) as is required in the case of partnerships, in lieu of Form 990 (Revised May 1944). With respect to group returns, see paragraph (f) of this section. For proof and establishment of right to exemption from tax which must accompany Form 990 (Revised May 1944) in the case of an organization which has not established its right to such exemption prior to the filing of the annual return, see paragraphs (a) and (b) of this section.

(f) *Group returns.* A central, parent, or like organization (referred to in this section as central organization), although required to file a separate annual return for itself under section 54 (f) and paragraph (e) of this section, may file annually, in addition to such separate annual return, a group return on Form 990 (Revised May 1944), for two or more of the local organizations, chapters, or the like (referred to in this section as "local organizations") which are (1) chartered by, or affiliated or associated with, such central organization at the close of its annual accounting period, (2) subject to the general supervision of, and examination by, the central organization, and (3) exempt from tax under the same provision of section 101 under which the central organization is exempt from tax. The filing of the group return shall be in lieu of the filing of a separate return by each of the local organizations included in the group return. The group return shall include only those local organizations which in writing have authorized the central organization to include them in the group return, and which have made and filed, with the central organization, their statements, verified under oath or affirmation, specifically stating their items of gross income, receipts, and disbursements, and such other information relating to them which is required to be stated in the group return, and such authorizations and statements shall be permanently retained by the central organization. There shall be attached to the group return and made a part thereof a schedule showing the name and address of each of the local organizations and the total number thereof included in such return, and a schedule showing the name and address of each of the local organizations and the total number thereof not included in the group return. The group return shall be on the basis of the established annual accounting period of the central organization. Where such central organization has no established annual accounting period, such return shall be on the basis of the calendar year. The same income, receipts, and disbursements of a local organization shall not be included in more than one group return. The group return shall be filed in accordance with these regulations and the instructions on Form 990 (Revised May 1944) or issued therewith, and shall be considered the return of each of the local organizations included therein. For proof and establishment of right to exemption from tax which must accompany Form 990 (Revised May 1944) in the case of a local organization included in the group return but which has not established its right to such exemption prior to the filing of the group return, see paragraphs (a) and (b) of this section.

(g) *Date for filing annual returns.* The annual return of information, Form 990 (Revised May 1944), for accounting periods beginning after December 31, 1942, but ending prior to April 1, 1944,

shall be filed on or before August 15, 1944, and for accounting periods beginning after December 31, 1942, but ending after March 31, 1944, shall be filed on or before the 15th day of the fifth full calendar month following the close of the period for which the return is required to be filed.

(h) *Organizations not required to file annual returns.* Annual returns, Form 990 (Revised May 1944), are not required to be filed by an organization which has established its right to exemption from tax under section 101 (6), if:

(1) It is organized and operated exclusively for religious purposes;

(2) It is operated, supervised, or controlled by or in connection with such religious organization;

(3) It is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(4) It is a charitable organization, or an organization for the prevention of cruelty to children or animals, which is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or which is primarily supported by contributions of the general public.

The annual return on Form 990 (Revised May 1944) need not be filed by a fraternal beneficiary society, order, or association, which has established its exemption from tax solely under section 101 (3), or by an organization exempt from tax under section 101 (15) if it is a corporation wholly owned by the United States or any agency or instrumentality thereof, or is a wholly-owned subsidiary of such a corporation.

An organization organized and operated exclusively for charitable purposes or for the prevention of cruelty to children or animals is not "primarily supported by contributions of the general public" for any accounting period if more than 50 percent of its income and receipts for such period are not actually derived from voluntary contributions and gifts made by the general public, as distinguished from a few contributors or donors or from related or associated persons. For the purposes of the preceding sentence the words "related or associated persons" refer to persons or a particular group who are connected with or are interested in the activities of the organization such as founders, incorporators, shareholders, members, fiduciaries, officers, employees, or the like, or who are connected with such persons by family or business relationship.

An educational organization which normally maintains and has a regular faculty, curriculum and student body and meets the above conditions which relieve it from the requirement of filing annual returns shall not be considered as having thereafter failed to continue meeting such conditions if it is temporarily compelled to curtail or discontinue its normal and regular activities during the existence of abnormal circumstances and conditions.

(i) *Collectors' records.* Collectors will keep a list of all organizations held to be exempt from tax to the end that they may occasionally inquire into their status and ascertain whether or not they are (1) observing the conditions upon which their exemption is predicated, and (2) annually filing returns on Form 990 (Revised May 1944) if they are required to file such returns.

(j) *Records, statements and other returns of tax-exempt organizations.* An organization which has established its right to exemption from tax under section 101 and has also established that it is not required to file annually the return of information on Form 990 (Revised May 1944) shall immediately notify in writing the collector for the district in which is located its principal office of any changes in its character, operations or purpose for which it was originally created.

Every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the Commissioner for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of section 54 (f) and this section. For requirement as to keeping of permanent books of account or records, see § 29.54-1.

An organization which has established its right to exemption from tax under section 101, including an organization which is relieved under section 54 (f) and these regulations from filing returns of income or annual returns of information, is not, however, relieved from the

duty of filing other returns of information (see sections 147 and 148).

[T. D. 5381, 9 F. R. 7123]

§ 29.102-1 *Taxation of corporation formed or utilized for avoidance of surtax.* Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 501, and foreign personal holding companies, as defined in Supplement P (see section 331), are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

A foreign corporation, whether resident or nonresident, formed or availed of for the purpose specified in section 102 is subject to the tax imposed thereby if it derives income from sources within the United States as defined in section 119 and the regulations thereunder, if any of its shareholders are (1) citizens or residents of the United States and therefore subject to the surtax with respect to distributions of the corporation or (2) nonresident alien individuals who, by the application of section 211 (b) or section 211 (c), would be subject to the surtax with respect to distributions of the corporation which if made would constitute income from sources within the United States (see section 119) or (3) foreign corporations if any beneficial interest therein is owned directly or indirectly by any shareholder specified in (1) or (2). On the other hand, the tax imposed by section 102 will not apply even though a foreign corporation, whether resident or nonresident derives income from sources within the United States, if all of its shareholders are nonresident alien individuals who, by the application of section 211 (a), would not be subject to surtax with respect to distributions of the corporation if made.

For the computation of the surtax see § 29.102-4.

§ 29.102-2 *Purpose to avoid surtax; evidence; burden of proof; definition of holding or investment company.* (a) The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the Internal Revenue Code, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the purpose of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered (1) dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the

corporation was not formed or availed of to avoid surtax upon shareholders.

(b) If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation is a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is determinative of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all evidence that the absence of such a purpose is unmistakable.

(c) A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

§ 29.102-3 *Unreasonable accumulation of profits.* (a) An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

(b) The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The business of one corporation may not be regarded as including the business of another unless the other corporation is a mere instrumentality of the first; to establish this it is ordinarily essential that the first corporation own all or substantially all of the stock of the second.

(c) The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated earnings and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

§ 29.102-4 *Computation of undistributed section 102 net income.* In ascertaining the tax basis for corporations subject to the provisions of section 102, the "section 102 net income" is first computed. This is accomplished in the case of a domestic corporation by subtracting from the corporate net income (as defined in sections 21 and 204) computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year beginning after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), (a) Federal income, war-profits, and excess-profits taxes (other than the tax imposed by subchapter E of chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23 (c), but not including the graduated income tax or surtax imposed by section 102 or corresponding sections of prior Revenue Acts; (b) contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) and § 29.23 (o)-1 for the purposes therein specified; (c) losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d) for the taxable year; (d) the credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e). For taxable years beginning after December 31, 1945, the excess profits tax imposed by subchapter E of chapter 2 is not applicable. For taxable years beginning in 1945 and ending in 1946, see § 29.108-2. In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return the "section 102 net income" means the net income from sources within the United States (gross income from sources within the United States, as defined in section 119 and the regulations thereunder, less statutory deductions) minus the amount of the deductions enumerated in (a), (b), (c), and (d) above. In the case of a foreign corporation, whether resident or nonresident, which files no return the "section 102 net income" means the gross income from sources within the United States, as defined in section 119 and the regulations thereunder, without the benefit of the deductions enumerated in paragraphs (a), (b), (c) and (d) of this section or any other deductions. (See section 233.) In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the corporate net income is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under the provisions of section 47 (c).

The "section 102 net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "section 102 net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

The "undistributed section 102 net income" is computed by subtracting from the "section 102 net income" described above, the amount of the basic surtax credit provided in section 27 (b). In computing the basic surtax credit for the purpose of section 102, the credit under section 27 (b) (1) is not to be reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335 and T. D. 5517, 11 F R. 6532]

§ 29.104-1 *Tax on banks.* A bank, as defined in section 104 (a), is, under section 104 (b), subject to the tax imposed by section 13 if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b). if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a bank is also subject to the surtax imposed by section 15 (see § 29.15-1).

§ 29.105-1 *Surtax on sale of oil or gas properties.* (a) If the taxpayer by prospecting and locating claims, or by exploring or discovering undeveloped claims, has demonstrated the principal

value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by section 12 attributable to a sale of such property or of the taxpayer's interest therein shall not exceed 30 percent of the selling price. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 105 to a particular case, the taxpayer should first compute the surtax imposed by section 12 upon his entire surtax net income, including the net income from any sale of such property or interest therein, without regard to section 105. The proportion of the surtax, so computed, indicated by the ratio which the taxpayer's net income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds 30 percent of the selling price of such property or interest, such portion of the surtax shall be reduced to that amount.

(b) In determining the portion of the net income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived, from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the net income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

§ 29.106-1 *Surtax on certain amounts received from the United States.* The method of computation provided for in § 29.105-1, relating to the limitation on surtax on the sale of oil or gas properties, shall be applicable in computing, under section 106, the surtax imposed by section 12 attributable to certain amounts received by the taxpayer from the United States under a claim involving acquisition of his property. The surtax limitation provided in section 106 is not applicable to any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment.

§ 29.107-1 *Personal services.* (a) Section 107 (a) provides that if at least 80 percent of the total compensation for personal services covering a period of 36 calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, then the tax attributable to any part of such amount which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had such part been included in the gross income of such individual ratably over that part of the period of service which precedes the date of such receipt or accrual. Thus, for example, if an individual who makes his returns on a calendar year basis and on the basis of cash receipts and disbursements commences personal services on February 17, 1942, and completes them on July 1, 1945, and is paid $8,000 for such services on the completion date, he is entitled to the benefits of section 107 (a), provided the $8,000 is at least 80 percent of the total compensation paid or to be paid to such individual for such services; and the tax attributable to the $8,000 received in 1945 and included in the individual's gross income for such year shall not be greater than the tax attributable to such amount, had it been received ratably over the calendar months included in the period from February 17, 1942, to July 1, 1945. However, if such individual receives an additional $5,000 in 1946 for such services, he is not entitled to the benefits of section 107 (a) with respect to either the $8,000 or the $5,000, for the reason that he does not receive in one taxable year at least 80 percent of the total compensation for such services. Also, for example, if an individual who makes his returns on the calendar year basis and on the basis of cash receipts and disbursements commences personal services on March 3, 1940, and completes them on August 22, 1943, and is paid a total compensation of $10,000 for such services on July 5, 1942, he is entitled to the benefits of section 107 (a); and the tax attributable to the $10,000 received in 1942 and in-

cluded in such individual's gross income for such year shall not be greater than the tax attributable to such amount, had it been received ratably over the calendar months included in the period from March 3, 1940, to July 5, 1942, the date on which the $10,000 was received. However, if such individual receives an additional $7,000 for such services on May 1, 1943, he is not entitled to the benefits of section 107 (a) for the reason that he does not receive in one taxable year at least 80 percent of the total compensation for such services.

(b) It is immaterial when the personal services are rendered provided at least 36 calendar months elapse from the beginning to the completion of the services. For the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(c) It is not necessary, in order for section 107 (a) to be applicable, that the individual who includes in his gross income compensation for such personal services be the person who renders the services. For example, a partner who shares in the compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107 (a), notwithstanding that he took no part in the rendering of such services.

(d) The first step in determining whether the limitation in section 107 (a) relative to the amount of tax is applicable is the computation of the amount of tax in the current taxable year attributable to that part of the compensation which is included in the gross income of the taxpayer for such year. The tax attributable to such compensation is the difference between the tax for such taxable year computed with the inclusion of such compensation in gross income and the tax for such taxable year computed without including such compensation in gross income.

(e) The next step is to compute the tax attributable to such compensation in each of the taxable years (including the current taxable year) within which falls one or more calendar months included in the part of the period of service which precedes the date such compensation is received or accrued, as if the compensation had been received or accrued in equal portions in each of such calendar months. For what constitutes a taxable year, see section 48 (a). The amount of the tax attributable to such compensation in each such taxable year is the difference between the tax for such year computed with the inclusion of an allocable portion of such compensation in gross income and the tax for such year computed without including any part of such compensation in gross income. The portion of the compensation allocable to each such taxable year is an amount equal to the entire amount of such compensation received or accrued in the current taxable year, divided by the entire number of calendar months included within the part of the period of service which precedes the date such compensation is received or accrued, and multiplied by the number of such calendar months falling within the particular taxable year.

(f) The tax for the current taxable year shall be the tax for such year computed without including the compensation for personal services in gross income, plus (1) the amount of tax for such taxable year attributable to such compensation (computed in accordance with the second preceding paragraph) or (2) the sum of the taxes attributable to such compensation had it been received in equal portions in each of the calendar months included within the part of the period of service which precedes the date such compensation is received or accrued (computed in accordance with the preceding paragraph), whichever is the smaller.

(g) The method of allocating compensation for personal services to the taxable years in which falls any of the calendar months included within the part of the period of service which precedes the date such compensation is received may be illustrated by the following examples, in each of which the taxpayer makes his return on the cash receipts and disbursements basis:

Example (1). On November 1, 1942, A, an indivdual, who makes his income tax returns on a calendar year basis, receives $40,000, the entire compensation for the performance of personal services covering a 40-month period beginning on June 1, 1939, and ending on September 30, 1942. For the purpose of determining whether the aggregate of the taxes attributable to the $40,000 compensation, had it been received in equal portions in each of the calendar months included within the part of the period of service which precedes the date the compensation is received (in this case the entire period of service), is less than the tax attributable to such

compensation in the taxable year 1942, $1,000 ($40,000 divided by 40) must be allocated to each of the calendar months included within the period of service. Thus $7,000 is allocated to 1939, $12,000 to 1940, $12,000 to 1941, and $9,000 to 1942 (the current taxable year).

Example (2). Assume the same facts as in example (1) except that A makes his income tax returns on the basis of the fiscal year July 1 to June 30. The $40,000 is allocated as follows: $1,000 to the taxable year ended June 30, 1939, $12,000 each to the taxable years ended June 30, 1940, June 30, 1941, and June 30, 1942, and $3,000 to the taxable year ending June 30, 1943 (the current taxable year).

Example (3). Assume the same facts as in example (1) except that A receives the $40,000 on February 1, 1942 (before completion of the services), instead of November 1, 1942. There are 32 calendar months included within the part of the period of service which precedes the date the compensation is received. Accordingly, $1,250 ($40,000 divided by 32) must be allocated to each of the calendar months included within the period from June 1, 1939, to February 1, 1942. Thus $8,750 is allocated to 1939, $15,000 to 1940, $15,000 to 1941, and $1,250 to 1942 (the current taxable year).

Example (4). B, an individual, who makes his income tax returns on a calendar year basis, renders personal services covering a 40-month period beginning on May 1, 1939, and ending on August 31, 1942. The total compensation for such services is $74,000, of which $34,000 is paid to B on March 1, 1942, and $40,000 on August 31, 1942. Using the method of allocation illustrated in example (1), the $40,000 payment must be allocated to the 40 calendar months included within the entire period of service. Accordingly, with respect to the $40,000 payment, $8,000 is allocated to 1939, $12,000 to 1940, $12,000 to 1941, and $8,000 to 1942 (the current taxable year). Using the method of allocation illustrated in example (3), the $34,000 payment must be allocated to the 34 calendar months included within the part of the period of service which precedes the date such payment is received (March 1, 1942). Accordingly, with respect to the $34,000 payment, $8,000 is allocated to 1939, $12,000 to 1940, $12,000 to 1941, and $2,000 to 1942 (the current taxable year). The entire compensation of $74,000 will, therefore, be allocated as follows: $16,000 to 1939, $24,000 to 1940, $24,000 to 1941, and $10,000 to 1942 (the current taxable year).

(h) If an individual, in computing his income tax for a particular taxable year, avails himself of the benefits of section 107 (prior or subsequent to its amendment by section 139 of the Revenue Act of 1942) with respect to compensation received or accrued in such year for personal services, and in a subsequent taxable year receives or accrues compensation for other personal services, all or a part of the period of which services is the same as the period of the services for which he was compensated in the previous taxable year, then he must, in availing himself of the benefits of section 107 for such subsequent taxable year, take into consideration the fact that he has previously allocated compensation to all or a part of the period of service. For example, an individual commences the performance of personal services for A on January 1, 1937, and completes them on December 31, 1941. On December 31, 1941, he receives $60,000 in full compensation therefor. In his return for the calendar year 1941, he allocates $1,000 to each of the 60 calendar months included within the period of service and determines his income tax under the provisions of section 107 (a). He also commences the performance of personal services for B on January 1, 1939, and completes them on December 31, 1942. On December 31, 1942, he receives $48,000 in full compensation therefor. If he wishes to avail himself of the benefits of section 107 (a) in his return for the calendar year 1942, he must, in allocating $1,000 to each of the 48 calendar months included within the period of service and computing the tax attributable thereto, include in his income for the years 1939, 1940, and 1941, for the purposes of the tentative computation, the amount of $12,000 previously allocated to each of such years in his return for the calendar year 1941.

§ 29.107–2 *Artistic work or invention.* (a) Section 107 (b) provides that if, in the taxable year, the gross income of an individual from an artistic work or invention of such individual covering a period of 36 calendar months or more (from the beginning to the completion thereof) is not less than 80 percent of the sum of the gross income therefrom in the taxable year, and the gross income therefrom in previous taxable years and in the 12 months following the close of the taxable year, then the tax attributable to such gross income in the taxable year shall not be greater than the aggregate of the taxes attributable thereto had it been received ratably over the part of the period of the work which precedes the close of the taxable year, or a period of 36 calendar months, whichever of such periods is the shorter. That part of the gross income from such artistic work or

invention which is taxable as a gain from the sale or exchange of a capital asset held for more than six months is excluded from the benefits of section 107 (b).

(b) For the purposes of this section, the term "artistic work or invention" means a literary, musical, or artistic composition, or a patent or copyright covering an invention or a literary, musical, or artistic composition. Also, for the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(c) The first step in determining whether the limitation in section 107 (b) relative to the amount of tax is applicable is the computation of the amount of tax in the current taxable year attributable to the gross income received or accrued in such year from the artistic work or invention. The tax attributable to such income is the difference between the tax for such taxable year computed with the inclusion in gross income of the gross income from the artistic work or invention and the tax for such taxable year computed without including in gross income the gross income from the artistic work or invention.

(d) The next step is to compute the tax attributable to the gross income from the artistic work or invention in each of the taxable years (including the current taxable year) within which falls one or more of the calendar months included within the part of the period of work which precedes the close of the current taxable year (not, however, exceeding 36 calendar months), as if the gross income from the artistic work or invention had been received or accrued in equal portions in each of such calendar months. For what constitutes a taxable year, see section 48 (a). The amount of tax attributable to gross income in each such taxable year from the artistic work or invention is the difference between the tax for such year computed with the inclusion in gross income of the gross income from the artistic work or invention and the tax for such year computed without including in gross income any part of the gross income from the artistic work or invention. The portion of the gross income from the artistic work or invention allocable to each such taxable year is an amount equal to the entire amount of the gross income from the artistic work or invention received or accrued in the current taxable year, divided by the entire number (not to exceed 36) of calendar months included within the part of the period of work which precedes the close of the current taxable year, and multiplied by the number of such calendar months falling within the particular taxable year.

(e) The tax for the current taxable year shall be the tax for such year computed without including in gross income the gross income from the artistic work or invention, plus whichever of the following is the smaller: (1) The amount of tax for such taxable year attributable to the gross income from the artistic work or invention (computed in accordance with the second preceding paragraph) or (2) the sum of the taxes attributable to the gross income from the artistic work or invention had it been received in equal portions in each of the calendar months (not exceeding 36 calendar months) included within the part of the period of work which precedes the close of the current taxable year (computed in accordance with paragraph (d) of this section).

(f) The method of allocating the gross income from the artistic work or invention to the taxable years in which falls any of the calendar months (not exceeding 36 calendar months) included within the part of the period of work which precedes the close of the current taxable year may be illustrated by the following examples:

Example (1). On October 1, 1942, A, an individual, who makes his returns on a calendar year basis and on the basis of cash receipts and disbursements, receives $36,000 in full payment for a musical composition, the work on which was commenced by A on July 10, 1938, and completed on January 29, 1943. Although the period of work covers 55 calendar months, allocations may be made to only the last 36 calendar months included within the part of the period of work which precedes the close of 1942 (the current taxable year). Therefore, $1,000 ($36,000 divided by 36) must be allocated to each of the 36 calendar months preceding January 1, 1943. Accordingly, $12,000 is allocated to 1940, $12,000 to 1941, and $12,000 to 1942 (the current taxable year).

Example (2). Assume the same facts as in example (1) except that the period of work was commenced by A on July 1, 1941, and completed on September 1, 1944. Although the period of work covers 38 calendar months, allocations may be made to only the 18 calendar months which are included within the part of the period of work which precedes

the close of 1942 (the current taxable year). Therefore, $2,000 ($36,000 divided by 18) must be allocated to each of 18 calendar months preceding January 1, 1943. Accordingly, $12,000 is allocated to 1941, and $24,000 to 1942 (the current taxable year).

(g) The principles set forth in the last paragraph of § 29.107-1, relating to the manner of allocating compensation for personal services to a particular calendar month where an allocation for other such services has previously been made to such month, are also applicable with respect to allocations under section 107 (b).

§ 29.107-3 *Back pay attributable to prior taxable years.* (a) Section 107 (d) (2) defines "back pay" and section 107 (d) (1) limits the amount of tax resulting from the inclusion of such back pay in gross income for the year in which it is received or accrued. Back pay includes compensation, wages, salaries, pensions and retirement pay received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the following events: (1) bankruptcy or receivership of the employer; (2) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (3) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (4) any other event determined to be similar in nature under these regulations. As to what constitutes bankruptcy and receivership proceedings see § 29.274-1.

(b) An event will be considered similar in nature to those events specified in section 107 (d) (2) (A) (i), (ii) and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payment of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued. For the purposes of this section the term "back pay" does not include remuneration which is deemed to be constructively received in the taxable year or years in which the services were performed, remuneration paid in the current year in accordance with the usual practice or custom of the employer even though received in respect of services performed in a prior year or years, additional compensation for past services where there was no prior agreement or legal obligation to pay such additional compensation, or any amount which is not includible in gross income under chapter 1.

(c) The term "back pay" also embraces retroactive wage or salary increases received or accrued in respect of services performed by an employee for his employer in a prior taxable year which have been ordered, recommended, or approved by any Federal or State agency such as, but not limited to, the War Labor Board or any regional War Labor Board, the Salary Stabilization Unit of the Bureau of Internal Revenue, and boards authorized by the Railway Labor Act (44 Stat. 577), as amended (45 U. S. C., ch. 8), comparable State organizations, and United States and State courts; payments made as a result of alleged violations of sections 6 and 7 of the Fair Labor Standards Act of 1938 (52 Stat. 1062 and 1063, as amended; 29 U. S. C., secs. 206 and 207), and made retroactive to any period prior to the taxable year; and payments which are received or accrued during the taxable year arising out of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, such as payments received to effectuate the policies of the National Labor Relations Act (49 Stat. 449), as amended (29 U. S. C., secs. 151-166). The term "wage or salary increases" as used in this section includes payments not made until after the close of the taxable year on account of regulations, orders, or rulings under the Inflation Control Act of 1942 (56 Stat. 765; 50 U. S. C., App., 961-971) even though the total amount paid for the services rendered does not exceed the amount payable by contract or under established policy.

(d) An individual must compute his net income for any taxable year to which back pay is attributable, even though he was not required to make a return for such year. Thus, all amounts properly includible as gross income for any taxable year to which back pay is attributable must be included in the computation.

(e) For the purpose of determining under section 107 (d) the particular taxable year or years to which the back pay is

attributable and, if such back pay is attributable to more than one taxable year, the amount thereof which is attributable to each of such taxable years, the following rules will be applicable:

(1) Back pay, as defined under section 107 (d) (2) (A), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year except for the intervention of one of the events described in section 107 (d) (2) (A).

(2) Back pay, as defined under section 107 (d) (2) (B), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year had the wage or salary increase as described in section 107 (d) (2) (B) been actually put into effect on the date to which it was first made retroactive.

(3) Back pay, as defined under section 107 (d) (2) (C), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it represents payments in respect of the alleged violation described in section 107 (d) (2) (C) which occurred in such year or which continued during any part of such year.

(4) In those cases where a computation has been made by, or under the direction of, a Federal or State agency (including any Federal or State court) under which the back pay was awarded, which indicates that particular portions of such back pay are attributable to certain definite periods of time, such computation shall be accepted as the appropriate apportionment for the purposes of this section.

(5) Where no such computation has been made as provided in subparagraph (4) of this paragraph, and where the apportionment cannot be accurately made upon consideration of all the attendant circumstances in accordance with the applicable rule prescribed in subparagraph (1), (2), or (3) of this paragraph, then in proper cases the back pay shall be apportioned to each of the taxable years within which fall one or more calendar months included within the entire period for which such back pay has been paid, as if such back pay had been received or accrued in equal portions in each of such calendar months. For the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

(f) The first step in determining whether section 107 (d) is appliicable is the determination of the percentage which the back pay is of the gross income of the taxpayer for the current taxable year. It must exceed 15 per centum of such gross income. The amount of the tax attributable to such back pay is the difference between the tax for the taxable year computed with the inclusion of such back pay in gross income and the tax for such taxable year computed without including such back pay in such gross income.

(g) The amount of the tax attributable to such back pay in each taxable year is the difference between the tax for such taxable year computed with the inclusion in gross income of the portion of such back pay attributable to such taxable year and the tax for such taxable year computed without including any part of such back pay in gross income.

(h) The tax for the current taxable year is (1) the tax computed with the inclusion in gross income of the entire back pay received or accrued in the taxable year, or (2) the tax computed without including any such back pay in gross income for the current taxable year, plus the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for each taxable year to which each such portion is respectively attributable, whichever is the smaller.

(i) This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1944 and 1941 the alternative tax provided in Supplement T:

Example. In 1944 a single person with no dependents who makes his income tax returns on the calendar year basis receives $2,900, which amount constitutes his adjusted gross income. Of this amount $500 constitutes back pay. His tax for the calendar year 1944 on $2,900 would be $490. On $2,400 ($2,900 minus $500) the tax would be $384. That part of the tax for 1944 attributable to back pay is therefore $106 ($490 minus $384). Of the back pay $300 is attributable to the year 1941. During such year he had received $2,000. For such year the amount of tax on $2,000 is $104. The amount of tax which he would have paid for such year had he included

in gross income the portion of back pay attributable to such year would be $130. The increase in the tax for such year would be $26 ($130 minus $104).

The remainder of the back pay, $200, is attributable to the calendar year 1940. During such year his net income was $1,800. For such year the amount of tax, including the defense tax, on $1,800 is $36.08 and the amount of tax, including the defense tax, which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $44. The increase in the tax for such year would be $7.92 ($44 minus $36.08). The aggregate of increases in the taxes for the calendar years 1941 and 1940 would be $33.92. The tax for the calendar year 1944 is the smaller of $384 plus (1) $106 or (2) $33.92. Since $33.92 is smaller than $106 the tax for the calendar year 1944 is $417.92 ($384 plus $33.92).

(j) Section 6 (d) (3) of the Current Tax Payment Act of 1943, as amended by section 506 (b) of the Revenue Act of 1943, provides that section 107 of the Internal Revenue Code shall be applied without regard to subsections (a) and (b) of section 6 of the Current Tax Payment Act of 1943. For example, a taxpayer who had received or accrued compensation including back pay in 1943 determines his income tax, including the victory tax, for such year in the manner provided in section 107 of the Internal Revenue Code before the application of section 6. In the process of determining such tax, portions of such compensation are attributable to prior years and the limitation upon the increase in the tax for 1943 attributable to such compensation is determined by reference to the tax for the respective years computed upon the portion of such compensation allocable to such years. While all of such compensation is included in gross income for 1942 or 1943, as the case may be, such compensation is attributable to prior years without regard to section 6 of the Current Tax Payment Act of 1943. This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1943, 1942 and 1941 the alternative tax provided in Supplement T:

Example. In 1943 a single person (not the head of a family) who makes his income tax returns on a calendar year basis receives $2,200. Of this amount $600 constitutes back pay. Including the victory tax, his tax liability for 1943 on $2,200 would be $342.10. On $1,600 ($2,200 minus $600) the tax liability would be $216.60. That part of the tax liability for the calendar year 1943 attributable to back pay is therefore $125.50 ($342.10 minus $216.60). Of the back pay $400 is attributable to the calendar year 1942. During such year he had received $1,000. For the calendar year 1942 the amount of tax liability on $1,000 is $76. The amount of tax liability for such year had he included in gross income the portion of back pay attributable to the calendar year 1942 would be $145. The increase in the tax liability for such year would be $69 ($145 minus $76).

The remainder of the back pay, $200, is attributable to the calendar year 1941. During such year he had received $1,000. For such year the amount of tax on $1,000 is $18, and the amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to the year 1941 would be $35. The increase in the tax for such year would be $17 ($35 minus $18). The aggregate of the increases in the taxes for the calendar years 1942 and 1941 would be $86. The tax liability for the calendar year 1943 is the smaller of $216.60 plus (1) $125.50 or (2) $86. Since $86 is smaller than $125.50, the tax liability for the calendar year 1943, prior to the application of section 6 of the Current Tax Payment Act of 1943, is $302.60. For the application of section 6 of the Current Tax Payment Act of 1943, see the regulations thereunder, set forth in Treasury Decision 5300, approved October 1, 1943, and amendments thereto.

[T. D. 5389, 9 F. R. 7744]

§ 29.108-1 *Computation of tax for taxable years beginning in 1943 and ending in 1944.* For a taxable year beginning in 1943 and ending in 1944, the normal tax, surtax, and victory tax imposed by sections 11, 12, and 450 upon taxpayers other than corporations, and the normal tax and surtax imposed by sections 13, 14, and 15 upon corporations shall be computed as follows:

(a) *Corporations.* In the case of a corporation, the normal tax and the surtax shall be the sum of the following:

(1) That portion of a tentative normal tax and surtax, computed under the law applicable to taxable years beginning on January 1, 1943, which the number of days prior to January 1, 1944, in the taxable year of the taxpayer bears to the total number of days in such taxable year, and

(2) That portion of a tentative normal tax and surtax, computed under the law applicable to taxable years beginning on January 1, 1944, which the number of days after December 31, 1943, in the taxable year of the taxpayer bears to the

total number of days in such taxable year.

(b) *Taxpayers other than corporations.* In the case of a taxpayer other than a corporation, the normal tax, surtax, and victory tax shall be the sum of the following:

(1) That portion of a tentative normal tax, surtax, and victory tax, computed under the law applicable to taxable years beginning on January 1, 1943, which the number of days prior to January 1, 1944, in the taxable year of the taxpayer bears to the total number of days in such taxable year, and

(2) That portion of a tentative normal tax and surtax, computed under the law applicable to taxable years beginning on January 1, 1944, which the number of days after December 31, 1943, in the taxable year of the taxpayer bears to the total number of days in such taxable year.

The provisions of section 108 apply to estates, trusts, and nonresident alien individuals whose tax is computed under sections 11 and 12. The method of computation prescribed in section 108 is not applicable, however, to an insurance company subject to Supplement G, an investment company subject to Supplement Q, or a Western Hemisphere Trade Corporation as defined in section 109.

The provisions of section 108 apply to a taxable year beginning in 1943 and ending in 1944, whether or not such taxable year is one of less than 12 months. In the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (b) and which due to a change in accounting period has a taxable year of less than 12 months, the net income shall be placed upon an annual basis under the provisions of section 47 (c) (1) for the purpose of both tentative tax computations under section 108 (b) (1) (A) and (B) or section 108 (b) (2) (A) and (B), or shall be computed under the exception in section 47 (c) (2), for the purpose of both such tentative tax computations. Regardless of the method adopted, the amounts of the tentative normal tax and surtax so computed upon the basis of 12 months' income shall be properly reduced under section 47 (c) in order to determine the tentative taxes under section 108 (b) (1) (A) and (B) or section 108 (b) (2) (A) and (B). However, in the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (b) and which due to any reason other than a change in accounting period has a taxable year of less than 12 months, the net income shall not be placed on an annual basis under section 47 (c) (1) and shall not be computed under the exception in section 47 (c) (2).

In any case in which the taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (b) has an excess of net long-term capital gains over net short-term capital losses, the alternative tax under section 117 (c) shall be an amount equal to the sum of the proper portions of the tentative taxes determined under section 108 (b) (1) (A) and (B) or section 108 (b) (2) (A) and (B), as the case may be, by computing each such tentative tax pursuant to the alternative tax computation provided in section 117 (c), regardless of whether either tentative tax so computed on the alternative basis is larger or smaller than the tentative tax computed without regard to section 117 (c).

In the case of a corporation whose taxable year begins in 1943 and ends in 1944, the credit under section 26 (e) for income subject to the tax imposed by Subchapter E of Chapter 2 (the excess profits tax), for the purposes of the first tentative tax computation provided in section 108 (b) (1) (A), shall be the adjusted excess profits net income used in computing the first tentative excess profits tax provided in section 710 (a) (6) (A), and for the purposes of the second tentative tax computation provided in section 108 (b) (1) (B), shall be the adjusted excess profits net income used in computing the second tentative excess profits tax provided in section 710 (a) (6) (B) with the following exceptions:

In the case of a taxable year of a corporation of less than twelve months, the credit under section 26 (e) for income subject to excess profits tax, for the purpose of both tentative taxes under section 108 (b) (1) (A) and (B), shall be an amount computed as provided in §§ 29.47-1 or 29.47-2 (a) or (b), depending upon whether or not such taxable year is a year of less than 12 months because of a change in accounting period and upon whether the net income has been placed on an annual basis under section 47 (c) (1) or has been computed as the net income for a 12-month period

under the exception contained in section 47 (c) (2).

In the case of a corporation computing its excess profits tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), such credit for income subject tot excess profits tax shall be in the case of the tentative tax computed under section 108 (b) (1) (A), the amount of which the first tentative excess profits tax computed under the provisions of section 710 (a) (6) (A) without regard to the 80 percent limitation provided in section 710 (a) (1) (B) is 90 percent, and in the case of the tentative tax computed under section 108 (b) (1) (B), the amount of which the second tentative excess profits tax, similarly computed under the provisions of section 710 (a) (6) (B), is 95 percent.

With respect to the credit for income subject to the excess profits tax imposed by Chapter 2 E in case the corporation is entitled to use the excess profits credit based upon a constructive average base period net income, see § 29.26-4.

In the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, subject to the provisions of section 108 (b), any credit against the tax otherwise imposed by sections 11, 12, 13, 14, 15, and 450, such as the credit for taxes paid to a foreign country or possession of the United States under section 131, shall be deducted from, and any limitations contained in such credit shall be based upon, the tax computed under section 108 (b). However, in those instances in which a taxpayer other than a corporation computes the second tentative tax under section 108 (b) (2) (B) by taking into account the optional standard deduction under section 23 (aa) as added by section 9 of the Individual Income Tax Act of 1944, the following credits shall be computed only with respect to that portion of the first tentative tax determined under section 108 (b) (2) (A): All credits under section 131 with respect to taxes of foreign countries and possessions, and all credits with respect to taxes withheld at the source under section 143 (a) relating to interest on tax-free covenant bonds.

Example. Corporation A is a domestic manufacturing corporation which makes its income tax returns on the basis of a fiscal year ending March 31. For the fiscal year ended March 31, 1944, it had a gross income of $1,000,000, which did not include any dividends or interest. Its allowable deductions are $400,000, its excess profits credit is $200,000, and there are no adjustments to be made under section 711 in computing excess profits net income. Its adjusted excess profits net income for the purposes of the first tentative excess profits tax computed under section 710 (a) (6) (A) is $395,000, and for the purposes of the second tentative excess profits tax computed under section 710 (a) (6) (B) is $390,000. The normal tax and surtax of Corporation A for its fiscal year ended March 31, 1944, are $49,498.36 and $32,998.91, respectively, computed as follows:

(a) Computation of tentative taxes provided in section 108 (b) (1) (A):

Normal tax and surtax

1. Gross income	$1,000,000
2. Less deductions	400,000
3. Net income	600,000
4. Less credit under section 26 (e) for income subject to excess profits tax (adjusted net income for tentative excess profits tax under section 710 (a) (6) (A))	395,000
5. Normal tax net income and corporation surtax net income	205,000
6. Normal tax (24% of item 5)	49,200
7. Surtax (16% of item 5)	32,800

(b) Computation of tentative taxes provided in section 108 (b) (1) (B):

Normal tax and surtax

8. Net income (item 3)	$600,000
9. Less credit under section 26 (e) for income subject to excess profits tax (adjusted net income for tentative excess profits tax under section 710 (a) (6) (B))	390,000
10. Normal tax net income and corporation surtax net income	210,000
11. Normal tax (24% of item 10)	50,400
12. Surtax (16% of item 10)	33,600

(c) Computation of normal tax and surtax for fiscal year ended March 31, 1944:

13. Number of days in taxable year prior to January 1, 1944	275
14. Number of days in taxable year after December 31, 1943	91

Normal tax

15. Tentative normal tax computed in (a)	$49,200	
16. 275/366ths of $49,200		$36,967.21
17. Tentative normal tax computed in (b)	50,400	
18. 91/366ths of $50,400		12,531.15
19. Total normal tax		49,498.36

Surtax

20. Tentative surtax computed in (a)	32,800	
21 275/366ths of $32,800		24,644.81
22. Tentative surtax computed in (b)	33,600	
23 91/366ths of $33,600		8,354.10
24. Total surtax		32,998.91

[T. D. 5401, 9 F. R. 10450]

§ 29.108-2 *Computation of tax for taxable years beginning in 1945 and ending in 1946.* (a) For a taxable year beginning in 1945 and ending in 1946, the normal tax, surtax, and optional tax imposed by sections 11, 12, and 400 upon taxpayers other than corporations, and the normal tax and surtax imposed by sections 13, 14, and 15 upon corporations shall be computed as follows:

(1) That portion of a tentative tax computed under the law applicable to taxable years beginning on January 1, 1945, which the number of days prior to January 1, 1946, in the taxable year of the taxpayer bears to the total number of days in such taxable year, and

(2) That portion of a tentative tax computed under the law applicable to taxable years beginning on January 1, 1946, which the number of days after December 31, 1945, in the taxable year of the taxpayer bears to the total number of days in such taxable year.

(b) The provisions of section 108 apply to estates, trusts, and nonresident alien individuals whose tax is computed under sections 11 and 12. The method of computation prescribed in section 108 is not applicable, however, to an insurance company subject to Supplement G, an investment company subject to Supplement Q, or a Western Hemisphere Trade Corporation as defined in section 109.

(c) The provisions of section 108 apply to a taxable year beginning in 1945 and ending in 1946, whether or not such taxable year is one of less than 12 months. In the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (c) and which because of a change in accounting period has a taxable year of less than 12 months, the net income shall be placed on an annual basis under the provisions of section 47 (c) (1) for the purpose of both tentative tax computations under section 108 (c), or shall be computed under the exception in section 47 (c) (2) for the purpose of both such tentative tax computations. Regardless of the method adopted, the amounts of the tentative normal tax and surtax so computed upon the basis of 12 months' income shall be properly reduced under section 47 (c) in order to determine the tentative taxes under section 108 (c). However, in the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (c) and which because of any reason other than a change in accounting period has a taxable year of less than 12 months, the net income shall not be placed on an annual basis under section 47 (c) (1) and shall not be computed under the exception in section 47 (c) (2).

(d) In any case in which the taxpayer, whether a corporation or a taxpayer other than a corporation, which is subject to the provisions of section 108 (c) has an excess of net long-term capital gains over net short-term capital losses, the alternative tax under section 117 (c) shall be an amount equal to the sum of the proper portions of the tentative taxes determined under section 108 (c), by computing each such tentative tax pursuant to the alternative tax computation provided in section 117 (c), regardless of whether either tentative tax so computed on the alternative basis is larger or smaller than the tentative tax computed without regard to section 117 (c).

(e) Except as provided in this section, in the case of a corporation whose taxable year begins in 1945 and ends in 1946, the credit under section 26 (e) for income subject to the tax imposed by subchapter E of chapter 2 (the excess profits tax), for the purposes of the tentative tax computation provided in section 108 (c) (1), shall be the adjusted excess profits net income used in computing the tentative excess profits tax provided in section 710 (a) (7), and for the purposes of the tentative tax computation provided in section 108 (c) (2), no credit for income subject to the tax imposed by such subchapter E is allowable.

(f) In the case of a taxable year of a corporation of less than 12 months, the credit under section 26 (e) for income subject to excess profits tax, for the purpose of the tentative tax under section 108 (c) (1), shall be an amount computed as provided in § 29.47-1 or § 29.47-2 (a) or (b), depending upon whether or not such taxable year is a year of less than 12 months because of a change in accounting period and upon whether the net income has been placed on an annual basis under section 47 (c) (1) or has been computed as the net income for a 12-month period under the exception contained in section 47 (c) (2).

(g) In the case of a corporation computing its excess profits tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), such credit for income subject to excess profits tax shall be, in the case of the tentative tax computed under section 108 (c) (1), the amount of which the tentative excess profits tax computed under the provisions of section 710 (a) (7) without regard to the 80 percent limitation provided in section 710 (a) (1) (B) is 95 percent.

(h) With respect to the credit for income subject to excess profits tax imposed by chapter 2E for taxable years beginning before January 1, 1946, in case the corporation is entitled to use the excess profits credit based upon a constructive average base period net income, see § 29.26-4.

(i) In the case of a taxpayer, whether a corporation or a taxpayer other than a corporation, subject to the provisions of section 108 (c), any credit against the tax otherwise imposed by sections 11, 12, 13, 14, 15, and 400, such as the credit for taxes paid to a foreign country or possession of the United States under section 131, shall be deducted from, and any limitation in such credit shall be based upon, the tax computed under section 108 (c). However, in those instances in which an individual taxpayer computes a tentative tax under section 108 (c) by taking into account the optional standard deduction under section 23 (aa), the following credits shall not be allowed: all credits under section 131 with respect to taxes of foreign countries and possessions, and all credits with respect to taxes withheld at the source under section 143 (a), relating to interest on tax-free covenant bonds.

Example. Corporation A is a domestic manufacturing corporation which makes its income tax returns on the basis of a fiscal year ending March 31. For the fiscal year ended March 31, 1946, it had a gross income of $1,000,000, which did not include any dividends or interest. Its allowable deductions are $400,000, its excess profits credit is $200,000, and there are no adjustments to be made under section 711 in computing excess profits net income. Its adjusted excess profits net income for the purposes of the tentative excess profits tax computed under section 710 (a) (7) is $390,000. The normal tax and surtax of Corporation A for its fiscal year ended March 31, 1946, are $73,479.45 and $46,027.40, respectively, computed as follows:

(a) *Computation of tentative taxes provided in section 108 (c) (1).*

Normal tax and surtax	
1. Gross income	$1,000,000
2. Less deductions	400,000
3. Net income	600,000
4. Less credit under section 26 (e) for income subject to excess profits tax (adjusted net income for tentative excess profits tax under section 710 (a) (7))	390,000
5. Normal tax net income and corporation surtax net income	210,000
6. Normal tax (24 percent of item 5)	50,400
7. Surtax (16 percent of item 5)	33,600

(b) *Computation of tentative taxes provided in section 108 (c) (2).*

Normal tax and surtax	
8. Net income (item 3): Normal tax net income and corporation surtax net income	$600,000
9. Normal tax (24 percent of item 8)	144,000
10. Surtax (14 percent of item 8)	84,000

(c) *Computation of normal tax and surtax for fiscal year ended March 31, 1946.*

11. Number of days in taxable year prior to January 1, 1946	275
12. Number of days in taxable year after December 31, 1945	90

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Normal tax

13. Tentative normal tax computed in (a)	$50,400	
14. 275/365ths of $50,400		$37,972.60
15. Tentative normal tax computed in (b)	$144,000	
16. 90/365ths of $144,000		35,506.85
17. Total normal tax		73,479.45

Surtax

18. Tentative surtax computed in (a)	$33,600	
19. 275/365ths of $33,600		$25,315.07
20. Tentative surtax computed in (b)	$84,000	
21. 90/365ths of $84,000		20,712.33
22. Total surtax		46,027.40

[T. D. 5517, 11 F. R. 6533]

§ 29.109-1 *Western hemisphere trade corporations.* (a) Under the provisions of section 15 of a domestic corporation qualifying as a Western Hemisphere trade corporation is exempt from the surtax imposed upon corporations generally by section 15. To so qualify, the following tests must be met:

(1) Its entire business must be carried on within the geographical limits of North, Central, or South America, or in the West Indies, or in Newfoundland; and

(2) 95 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) must be derived from sources without the United States; and

(3) 90 percent or more of its gross income for such period or such part thereof must be derived from the active conduct of a trade or business.

A domestic corporation is not excluded from the exemption merely because, incident to the conduct of its trade or business, it retains title in goods to insure payment for such goods shipped to a country outside the geographical areas enumerated in section 109.

(b) A corporation which claims exemption as a Western Hemisphere trade corporation shall attach to its income tax return a statement showing that its entire business is done in one or more of the designated countries, and for the 3-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence) (1) its total gross income from all sources, (2) the amount thereof derived from the active conduct of a trade or business, (3) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (4) the amount of its gross income, if any, from sources within the United States. The gross income from sources without the United States and within the United States shall be determined as provided in section 119 and the regulations prescribed thereunder.

COMPUTATION OF NET INCOME

§ 29.111-1 *Computation of gain or loss.* (a) Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 111, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 113 (b) and §§ 29.113 (b) (1)-1 to 29.113 (b) (3)-2, inclusive (i. e., the cost or other basis provided by section 113 (a), adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained in the amount of the insufficiency. The basis may be different depending upon whether gain or loss is being computed.

(b) Even though property is not sold or otherwise disposed of, gain (includible in gross income under section 22 (a) as "gains or profits and income derived from any source whatever") is realized if the sum of all the amounts received which are required by section 113 (b) to

be applied against the basis of the property exceeds such basis. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof the Internal Revenue Code takes no account of it. The provisions of this paragraph may be illustrated by the following example:

Example. A purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1942, A's adjusted basis for the stock had been reduced to $1,000, by reason of receipts and distributions described in section 113 (b) (1) (A) and (D). He received in 1942 a further distribution of $5,000, being a distribution described in section 113 (b) (1) (D). This distribution applied against the adjusted basis as required by section 113 (b) (1) (D) exceeds that basis by $4,000. The amount of the excess, namely, $4,000, is a gain realized by A in 1942 includible, as a gain from the stock, in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 113 (b). If A sells the stock in 1943 for $5,000, he realizes in 1943 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(c) In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 44.

§ 29.112 (a)-1 *Sales or exchanges.* (a) The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

(b) Exceptions to the general rule are made by section 112 (b) (1) to (15), inclusive, section 112 (b) (10) and section 112 (1) in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(c) The Internal Revenue Code makes specific provision for the case in which, in addition to property which may be received tax free on the exchange, there is received as boot other property or money. In such a case gain is recognized to the extent of the boot (see section 112 (c) and (d), but no loss of any kind is recognized (see section 112 (e)).

(d) The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(e) To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, section 112 (b) (10) the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

(f) See section 112 (b) (6) and (7) with respect to nonrecognition of gain or loss upon the receipt of property distributed in complete liquidation of a corporation under certain specifically described circumstances. See sections 112 (b) (8) and 371 with respect to nonrecognition of gain or loss upon exchanges and distributions made in obedience to orders of the Securities and Exchange Commission. See section 510 of the Merchant Marine Act of 1936, as

added by section 7 of the Act of August 4, 1939 (53 Stat. 1183), with respect to nonrecognition of gain in case of the transfer of an obsolete vessel to the Maritime Commission under the provisions of such section.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5356, 9 F. R. 4323, T. D. 5402, 9 F. R. 11048]

§ 29.112 (a)-2 *Use of term "assumption of liabilities".* When used in the regulations prescribed under sections 112 and 113, the terms "assumption of liabilities," "liabilities assumed," or similar expressions include, in addition to cases where personal liabilites of the taxpayer are assumed by another party to the exchange, cases (1) where property of the taxpayer is acquired by another party to the exchange subject to a liability, whether or not the taxpayer was himself personally liable, and (2) where, though the property transferred was held by the taxpayer merely subject to a liability, the liability is assumed by another party to the exchange.

§ 29.112 (b) (1)-1 *Property held for productive use in trade or business or for investment.* (a) As used in section 112 (b) (1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(b) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(c) A transfer is not within the provisions of section 112 (b) (1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c).

(d) Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation.

§ 29.112 (b) (2)-1 *Stock for stock of the same corporation.* (a) The exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation is not limited to a transaction between a stockholder and the corporation; it includes an exchange between two individual stockholders. However, the provisions of section 112 (b) (2) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation.

(b) A transfer is not within the provisions of section 112 (b) (2) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c).

§ 29.112 (b) (5)-1 *Transfer of property to corporation controlled by transferor.* As used in section 112 (b) (5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 3797); and to be in "control" of the transferee corporation such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. (See section 112 (h).) The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Example (*1*). A owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $150,000 in 1942. He transfers this property to the M Corporation, a newly formed company, for all the latter's capital stock. No gain or loss is recognized on the transaction.

Example (*2*). C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example (*3*). B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1942. He transfers the property to the N Corporation in 1942 for 78 percent of each class of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112 (h).)

§ 29.112 (b) (5)-2 *Treatment of assumptions of liabilities*—(a) *Recognition of gain.* For the effect upon the recognition of gain of an assumption of liabilities in a transfer described in section 112 (b) (5), see section 112 (k) and the regulations prescribed thereunder.

(b) *Computation of proportionate interests required by section 112 (b) (5).* In any case where an assumption of liabilities is not to be treated as "other property or money" under section 112 (k), the liabilities so assumed are, for the purpose of determining whether the stock or securities received by the transferors are substantially proportionate to their interests in the property transferred as required by section 112 (b) (5), to be treated as stock or securities received by the transferor whose indebtedness is assumed. The application of this paragraph may be illustrated by the following example:

Example. A and B, individuals, each owns property with a fair market value of $100,000 on July 1, 1942. There is a purchase money mortgage on A's property of $50,000. On July 1, 1942, A and B organize the X Corporation, to which they transfer the property above described for the entire capital stock of the X Corporation and the assumption by the X Corporation of A's purchase money mortgage. The X Corporation's capital stock is divided as follows: $50,000 to A and $100,000 to B. Nevertheless, for the purposes of determining whether the transferors received stock or securities substantially in proportion to their interests in the properties transferred, as required by section 112 (b) (5), A is deemed to have received stock or securities to the extent of $100,000, since his $50,000 purchase money mortgage, assumed by the X Corporation, is also to be treated as stock or securities received by him. Accordingly, under the facts as stated, the proportions required by section 112 (b) (5) exist.

§ 29.112 (b) (5)-3 *Records to be kept and information to be filed.* (a) Every person who receives the stock or securities of a controlled corporation for property under section 112 (b) (5) shall file with his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A description of the property transferred, or of his interest in such property, together with a statement of the cost or other basis thereof, adjusted to the date of the transfer, and

(2) A statement of the amount of stock or securities and other property or money received in the exchange, includiny any liabilities of the taxpayer assumed by the controlled corporation. The amount of each kind of stock or securities and other property received shall be set forth at its fair market value at the date of the exchange.

(b) Every such controlled corporation shall file with its income tax return for the taxable year in which the exchange takes place:

(1) A full description of all property received from the transferors, together with a statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of the transfer, and

(2) A statement of the amount of stock or securities and other property or money which passed to the transferors in the transaction (including any liabilities assumed by such controlled corporation), together with a full statement of the amount of the issued and outstanding stock and securities of such controlled corporation immediately after the exchange and of the ownership of each transferor of each class of stock of such controlled corporation immediately after the exchange (showing as to each class the number of shares and percentage owned and the voting power of each share).

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange un-

der section 112 (b) (5) showing the cost or other basis in his hands of the transferred property, and of the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received in the exchange.

§ 29.112 (b) (6)-1 *Distributions in liquidation of subsidiary corporation*—(a) *General.* Under the general rule prescribed by section 115 (c) for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 111. The scope of this treatment is governed by the meaning of the term "amounts distributed in complete liquidation of a corporation" as used in section 115 (c). Section 112 (b) (6) excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of another corporation and provides for the nonrecognition of gain or loss in these cases which meet the statutory requirements. Section 112 (i) places a limitation on the application of section 112 (b) (6) in the case of foreign corporations. See § 29.113 (a) (15)-1 for the basis for determining gain or loss from the subsequent sale of property received upon complete liquidations such as described in this section.

(b) *Requirements for nonrecognition of gain or loss.* (1) The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in the liquidating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). The Internal Revenue Code expressly requires that the recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. The Code also expressly requires that the recipient corporation shall at no time, on or after the date of the adoption of the plan and until the receipt of the property, be the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

(2) The provisions of section 112 (b) (6) do not apply to any liquidation if any distribution in pursuance thereof has been made before the first day of the first taxable year of the recipient corporation beginning after December 31. 1935.

(3) To constitute a distribution in complete liquidation within the meaning of section 112 (b) (6), the distribution must be (i) made by the liquidating corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation or (ii) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. It is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). (See § 29.22 (a)-20.)

(4) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code and satisfies the requirements of section 112 (b) (6), it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan

for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 112 (b) (6), even though for purposes of those provisions in section 112 relating to reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 112 (b) (4) and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a tax-free exchange described in section 112 (b) (3). The application of this paragraph may be illustrated by the following example:

Example. On July 1, 1942, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On July 1, 1942, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of the common stock of the M Corporation. By a statutory merger consummated on August 1, 1942, pursuant to a plan of liquidation adopted on July 1, 1942, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the holders of the stock of the M Corporation not owned by the O Corporation in exchange for their stock in the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 112 (b) (6), and no gain or loss is recognized as the result of the receipt of such properties.

§ 29.112 (b) (6)-2 *Liquidations completed within one taxable year.* If in a liquidation completed within one taxable year, pursuant to a plan of complete liquidation, distributions in complete liquidation are received by a corporation which owns the specified amount of stock in liquidating corporation and which continues qualified with respect to the ownership of such stock until the transfer of all the property within such year is completed (see § 29.112 (b) (6)-1), then no gain or loss shall be recognized with respect to the distributions received by the recipient corporation. In such case no waiver or bond is required of the recipient corporation under section 112 (b) (6).

§ 29.112 (b) (6)-3 *Liquidations covering more than one taxable year.* If the plan of liquidation is consummated by a series of distributions covering a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall, in addition to the requirements of § 29.112 (b) (6)-1, be subject to the following requirements:

(a) In order for the distribution in liquidation to be brought within the exception provided in section 112 (b) (6) to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred in accordance with a plan of liquidation, which plan shall include a statement showing the period within which the transfer of the property of the liquidating corporation to the recipient corporation is to be completed. The transfer of all the property under the liquidation must be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.

(b) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall, at the time of filing its return, file with the collector for transmittal to the Commissioner a waiver of the statute of limitations on assessment. The waiver shall be executed on such form as may be prescribed by the Commissioner and shall extend the period for assessment of all income and profits taxes for each such year to a date not earlier than one year after the last date of the period for assessment of such taxes for the last taxable year in which the transfer of the property of the liquidating corporation to the controlling corporation may be completed in accordance with section 112 (b) (6). Such waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be

necessary to insure the assessment and collection of the correct tax liability for each year within the period of liquidation.

(c) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall file a bond, the amount of which shall be fixed by the Commissioner. The bond shall contain all terms specified by the Commissioner, including provisions unequivocally assuring prompt payment of the excess of income and profits taxes (plus penalty, if any, and interest) as computed by the Commissioner without regard to the provisions of sections 112 (b) (6) and 113 (a) (15) over such taxes computed with regard to such provisions, regardless of whether such excess may or may not be made the subject of a notice of deficiency under section 272 and regardless of whether it may or may not be assessed. Any bond required under section 112 (b) (6) shall have such surety or sureties as the Commissioner may require. However, see section 1126 of the Revenue Act of 1926, as amended, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal bonds will be approved as sureties. The bonds shall be executed in triplicate so that the Commissioner, the taxpayer, and the surety or the depositary may each have a copy.

(d) Pending the completion of the liquidation, if there is a compliance with paragraphs (a), (b), and (c) of this section and § 29.112 (b) (6)-1 with respect to the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 113 (a) (15). (See § 29.113 (a) (15)-1.) However, if the transfer of the property is not completed within the 3-year period allowed by section 112 (b) (6) or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 112 (b) (6) or section 113 (a) (15) and the amount of any additional tax due upon such recomputation shall be promptly paid.

§ 29.112 (b) (6)-4 *Distributions in liquidation as affecting minority interests.* Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 112 (b) (6), since it does not apply to that part of distributions in liquidations received by minority shareholders.

§ 29.112 (b) (6)-5 *Records to be kept and information to be filed with return.* (a) Permanent records in substantial form shall be kept by every corporation receiving distributions in complete liquidation within the exception provided in section 112 (b) (6) showing the information required by this section to be submitted with its return. The plan of liquidation must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of each such corporation.

(b) For the taxable year in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one year, for each taxable year in which a distribution is received under the plan, the recipient shall file with its return a complete statement of all facts pertinent to the nonrecognition of gain or loss, including:

(1) A certified copy of the plan for complete liquidation, and of the resolutions under which the plan was adopted and the liquidation was authorized, together with a statement under oath showing in detail all transactions incident to, or pursuant to, the plan.

(2) A list of all properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement as to its ownership of all classes of stock of the liquidating

corporation (showing as to each class the number of shares and percentage owned and the voting power of each share) as of the date of the adoption of the plan of liquidation, and at all times since, to and including the date of the distribution in liquidation, and the cost or other basis of such stock.

§ 29.112 (b) (7)-1 *Corporate liquidations in calendar month in 1944*—(a) *General.* Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within some one calendar month in 1944, for the treatment of gain on the shares of stock owned by qualified electing shareholders at the time of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and § 29.112 (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 February 25, 1944. Such plan may be adopted at any time after February 25, 1944, and before the first distribution under the liquidation occurs. The Code also requires that the transfer of all the property, both tangible and intangible, of the corporation under the liquidation occur entirely within some one calendar month in 1944, but this requirement will be considered to have been complied with if cash is set aside under arrangements for the payment, after the close of such month, of unascertained or contingent liabilities and expenses, and such arrangements are made in good faith and the amount set aside is reasonable. Though it is not necessary that the corporation dissolve in the month of liquidation, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.

If a transaction constitutes a distribution in complete liquidation within the meaning of the Code and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

[T. D. 5356, 9 F. R. 4323]

§ 29.112 (b) (7)-2 *Qualified electing shareholder.* (a) No corporate shareholder may be a qualified electing shareholder if at any time between December 10, 1943, 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.

(b) All other shareholders are divided into two groups for the purpose of determining whether they are qualified electing shareholders: (1) shareholders other than corporations, and (2) corporate shareholders.

(c) Any shareholder of either of such two groups, whether or not the stock he owns is entitled to vote on the adoption of the plan of liquidation, is a qualified electing shareholder if:

(1) His written election to be governed by the provisions of section 112 (b) (7), which cannot be withdrawn or revoked, has been made and filed as prescribed in § 29.112 (b) (7)-3; and

(2) Like elections have been made and filed by owners of stock possessing at least 80 percent of the total combined voting power of all classes of stock owned by shareholders of the same group at the time of, and entitled to vote upon, the adoption of the plan of liquidation, whether or not the shareholders making such elections actually realize gain upon the cancellation of redemption of such stock upon the liquidation.

Example. The R Corporation has outstanding 20 shares of common stock on July 1, 1944, at the time of the adoption of a plan of liquidation within the provisions of section 112 (b) (7), each entitled to one vote upon the adoption of such plan of liquidation. At that time ten of such shares are owned by the S Corporation, two each

by the X Corporation and the Y Corporation, one by the Z Corporation, and one each by A, B, C, D, and E, individuals. There are also outstanding at such time two shares of preferred stock, not entitled to vote on liquidation, one share being owned by F, an individual, and one share by the P Corporation. The S Corporation, being a corporate shareholder and the owner of 50 percent of the voting stock, may not be a qualified electing shareholder under any circumstances. In order for any other corporate shareholder to be a qualified electing shareholder, it is necessary that the X Corporation and the Y Corporation file their written elections to be governed by section 112 (b) (7). If this is done, the P Corporation will also be a qualified electing shareholder if it has filed a like election. Similarly, in the case of the individual shareholders, some combination of four of the individual holders of the common stock must have filed their written elections, before any individual shareholder may be considered a qualified electing shareholder, but if this is done, F will also be a qualified electing shareholder if he has filed a like election.

An election to be governed by the provisions of section 112 (b) (7) relates to the treatment of gain realized upon the cancellation or redemption of stock upon liquidation and can therefore be made only by or on behalf of the person by whom gains, if any, will be realized. Thus, the shareholder who may make such election must be the actual owner of stock and not a mere record holder, such as a nominee.

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 the transferee.

[T. D. 5356, 9 F. R. 4323]

§ 29.112 (b) (7)-3 *Making and filing of written elections.* An election to be governed by section 112 (b) (7) shall be made on Form 964 (revised) in accordance with the instructions printed thereon and with this part. The original and one copy shall be filed by the shareholder or by the liquidating corporation with the Commissioner of Internal Revenue, Washington 25, D. C., attention of the 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.

[T. D. 5356, 9 F. R. 4324]

§ 29.112 (b) (7)-4 *Treatment of gain*—(a) *Computation of gain.* As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (c), and gain from the receipt of such amounts is determined as provided in section 111. Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder at the time of the adoption of the plan of liquidation. The limited recognition and special treatment accorded by section 112 (b) (7) applies only to the gain on such shares of stock upon which gain was realized and not to net gain computed by setting off losses realized on some shares against gain on others.

(b) *Recognition of gain.* Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder at the time of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following:

(1) Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of the last day of the month of liquidation, without diminution by reason of distributions made during such month, and including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after December 10, 1943. The mere replacement after December 10, 1943, of lost or destroyed certificates or instruments acquired on or before December 10, 1943, 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 December 10, 1943." Nor will such an acquisition result from the issuance after December 10, 1943, of certificates of stock in connection with a subscription made and accepted on or before December 10, 1943.

(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 at the time of the adoption of the plan of liquidation which is not in excess of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. In the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized is treated and taxed as a short-term or long-term capital gain, as the case may be.

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 (computed as provided in section 112 (b) (7)), of $60, its assets consisting of property (other than stock or securities acquired after December 10, 1943, and money) with a fair market value of $240, cash of $75, and stock and securities acquired after December 10, 1943, with a fair market value of $90, all of which assets are distributed in October 1944 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 December 10, 1943, and is greater than his ratable share of the earnings and profits ($20). In the case of the corporate shareholders this amount is treated as capital gain. In the case of the individual shareholder, however, $20, being the amount of the shareholder's ratable share of the earnings and profits, is taxable to him as a dividend, and $35, being the difference between the shareholder's ratable share of the earnings and profits and the sum of the cash and stock and securities received by him, is recognized and treated as a short-term or long-term capital gain, as the case may be. The remainder of each shareholder's gain, $30, is not recognized. If the basis of each shareholder's stock had been $100, instead of $50, the corporate shareholders would be taxed on only $35 as capital gain and the individual shareholder on $20 as a dividend but only on $15 as a capital gain, since the total amount taxed is limited by the amount of gain realized by the shareholder upon the cancellation or redemption of his stock

[T. D. 5356, 9 F. R. 4324]

§ 29.112 (b) (7)-5 *Records to be kept and information to be filed with return.* Permanent records in substantial form shall be kept by every qualified electing shareholder receiving distributions in complete liquidation of a domestic corporation. Such shareholder shall file with his income tax return for his taxable year in which the liquidation occurs a statement of all facts pertinent to the recognition and treatment of the gain realized by him upon the shares of stock owned by him at the time of the adoption of the plan of liquidation, including:

(a) A statement of his stock ownership in the liquidating corporation as of the date of the distribution, showing the number of shares of each class owned on such date and the cost or other basis of each such share;

(b) A list of all the property including money received upon the distribution, showing the fair market value of each item of such property other than money on the date distributed and stating what items, if any, consist of stock or securities acquired by the liquidating corporation after December 10, 1943;

(c) A statement of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, computed without diminution by reason of distributions made during the month of liquidation; and

(d) A copy of such shareholder's written election to be governed by the provisions of section 112 (b) (7). (See § 29.112 (b) (7)-3.)

For information to be filed by the liquidating corporation, see section 148 (e).

[T. D. 5356, 9 F. R. 4324]

§ 29.112 (b) (9)-1 *Nonrecognition of loss upon transfer of property of railroad corporation.* For the purpose of section 112 (b) (9), it is unnecessary that the transfer be a direct transfer by the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 112 (g). It is sufficient if the transfer is made in pursuance of an order of the court and is an integral step

in the consummation of a plan of reorganization approved by the court having jurisdiction of the proceeding. If these conditions are satisfied, no loss is recognized to the transferor upon the ultimate transfer of the property, or to the transferor upon any intermediate transfer.

Section 112 (b) (9) applies only to a transfer resulting in a loss and has no application if the transfer therein described results in a gain.

§ 29.112 (b) (10)-1 *Transfer of property of insolvent corporation in reorganization in bankruptcy or receivership proceeding*—(a) *Exchange solely for stock or securities.* (1) Section 112 (b) (10) provides for the nonrecognition of gain or loss upon certain exchanges made in connection with the reorganization of an insolvent corporation, hereinafter referred to in these regulations as a "section 112 (b) (10) reorganization". The section does not apply with respect to a railroad corporation as defined in section 77m of the National Bankruptcy Act, as amended. In order to qualify as a section 112 (b) (10) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

(2) Section 112 (b) (10) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (1) Receivership, foreclosure or similar proceedings, or (2) bankruptcy proceedings under section 77B or Chapter X of the National Bankruptcy Act, as amended. The specific statutory requirements are the transfer of property of a corporation, in pursuance of an order of the court having jurisdiction of the corporation in such proceeding, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation. If the consideration for the transfer consists of other property or money as well as stock and securities, the gain, if any, is recognized in an amount not in excess of such other property and money (see section 112 (d)), but no loss is recognized (see section 112 (e)). As to the assumption of liabilities in an exchange described in section 112 (b) (10), see section 112 (k) and see §§ 29.112 (a)-2 and 29.112 (k)-1.

(3) Section 112 (b) (10) and so much of section 112 (d) and (e) as relates to section 112 (b) (10) are applicable to taxable years beginning after December 31, 1933, but do not operate to affect the tax liability for any taxable year beginning prior to January 1, 1943.

(4) The application of section 112 (b) (10) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.

(5) As used in section 112 (b) (10), the term "reorganization" is not controlled by the definition of "reorganization" contained in section 112 (g). However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 112 (g), are likewise essential to qualify a transaction as a reorganization under section 112 (b) (10). Among these requirements are a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Thus, the nonrecognition accorded by section 112 (b) (10) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. For the purpose of determining whether the requisite continuity of interest exists, the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest. But the mere possibility of a proprietary interest is not its equivalent. The determinative and controlling fac-

tors are the corporation's insolvency and the effective command by the creditors over its property. The term "insolvent" as used in this section refers to insolvency at any time during the course of the proceeding referred to in section 112 (b) (10), either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

(6) A short-term purchase money note is not a security within the meaning of section 112 (b) (10), and the transfer of the properties of the insolvent corporation for cash and deferred payment obligations of the transferee evidenced by short-term notes is a sale and not an exchange.

(b) *Exchange for stock or securities and other property or money.* If an exchange would be within the provisions of section 112 (b) (10) if it were not for the fact that the consideration for the transfer of the property of the insolvent corporation consists not only of stock or securities but also of other property or money, then, as provided in section 112 (d) (1), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. Property is distributed within the meaning of this section if it is paid over or distributed to shareholders or creditors who have by appropriate legal steps obtained effective command of the property of the corporation. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized, under the provisions of section 112 (d) (2), in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 112 (e)).

For the proper treatment of a transaction involving an assumption of liabilities under so much of section 112 (d) or (e) as relates to section 112 (b) (10), see section 112 (k) and the regulations prescribed thereunder.

[T. D. 5402, 9 F. R. 11048]

§ 29.112 (b) (10)-2 *Records to be kept and information to be filed.* For taxable years beginning after December 31, 1942, each corporation a party to a section 112 (b) (10) reorganization shall furnish a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the exchange, including:

(a) A certified copy of the plan of reorganization approved by the court in the proceeding, together with a statement showing in full the purposes thereof and in detail all transactions incident, or pursuant, to the plan;

(b) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan;

(c) A statement of the amount of stock or securities and other property or money received in the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the exchange;

(d) A statement of the amount and nature of any liabilities assumed upon the exchange.

The information required by this section shall be filed as a part of the corporation's return for its taxable year within which the reorganization occurred, except that in the case of a taxable year beginning in 1943 and ending before September 1, 1944, the statement containing such information shall be filed with the Commissioner of Internal Revenue, Washington 25, D. C., on or before December 15, 1944.

(e) 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 of other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

[T. D. 5402, 9 F. R. 11049]

§ 29.112 (c)-1 *Receipt of other property or money in tax-free exchange not connected with corporate reorganization.* (a) If in any transaction in which property held for investment or productive use in trade or business is exchanged for property of like kind to be held either for productive use or for investment; or

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 property is transferred by one or more persons to a corporation for its stock or securities, within the meaning of section 112 (b) (5), there is received by the taxpayer other property (in addition to property permitted to be received without recognition of gain) or money, then

(1) The gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example. A, who is not a dealer in real estate, in 1942 exchanges real estate, which he purchased (for investment) in 1921 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and he receives in addition $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

(b) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (b) (1) and (2). As to the proper treatment of such consideration for the purposes of so much of section 112 (c) as relates to section 112 (b) (3), see § 29.112 (g)-4; and so much of section 112 (c) as relates to section 112 (b) (5), see section 112 (k) and § 29.112 (k)-1.

(c) See section 113 (a) (6) for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this section.

(d) As to the receipt of other property or money on an exchange of stock or securities in connection with a section 112 (g) reorganization, see § 29.112 (g)-4; or in connection with a section 112 (b) (10) reorganization, see § 29.112 (l)-1. As to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see § 29.112 (g)-4, in the case of a section 112 (g) reorganization, or § 29.112 (l)-1, in the case of a section 112 (b) (10) reorganization.

§ 29.112 (e)-1 *Nonrecognition of loss.* The Internal Revenue Code provides that in no event shall a loss be recognized from a tax-free exchange of property under section 112 (b) (1) to (5) inclusive, or section 112 (b) (10), notwithstanding the fact that there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. The rule provided with respect to an exchange under so much of section 112 (e) as refers to section 112 (b) (10) shall not be applied to affect the tax liability for any taxable year beginning before January 1, 1943.

As to the nonrecognition of loss upon an exchange described in so much of section 112 (e) as refers to section (i), see § 29.112 (l)-1.

As to the basis of the property received in such an exchange for the purpose of determining gain or loss from the subsequent sale thereof, see section 113 (a) (6).

As to the nonrecognition of loss upon the receipt of property by one corporation in complete liquidation of another corporation under certain specifically described circumstances, see section 112 (b) (6).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11049]

§ 29.112 (f)-1 *Reinvestment of proceeds of involuntary conversion.* (a) Upon the involuntary conversion of property described in section 112 (f), no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 112 (f), the gain, if any, is recognized to the extent of the money which is not so expended. For example, a vessel purchased by A in 1939 for $100,000 is destroyed by an enemy submarine in 1942, and A receives in 1942 insurance in the amount of $100,000. This money is not expended in the manner provided in section 112 (f), but there is no gain since the insurance does not exceed the basis (disregarding, for the purposes of this example, the adjustment for depreciation). In 1947, A receives an award of $200,000 from the Government on account of the destruction of the vessel. He expends this amount in the manner provided in section 112 (f). The gain in 1947 upon the receipt of this award is recognized to the extent of $100,000, the amount of the money received in 1942 which was not expended in the manner

provided in section 112 (f). The loss sustained as a result of an involuntary conversion described in section 112 (f) is recognized. The expenditure in the manner provided in section 112 (f) of money received upon an involuntary conversion is not necessary for the transaction to be considered completed for the purpose of determining such loss.

(b) In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

(c) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(d) The provisions of section 112 (f) are applicable to property used for residential or farming purposes.

(e) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(f) 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.

(f) It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

§ 29.112 (f)-2 *Replacement funds.* In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately (for example, because of the taxpayer's inability to obtain priorities, or because of other wartime restrictions), he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Ace of 1926, as amended, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority

from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.

§ 29.112 (g)-1 *Purpose and scope of exception of reorganization exchanges.* As used in §§ 29.112 (g)-1 to 29.112 (g)-6, the terms "reorganization" and "party to a reorganization" mean only a reorganization or a party to a reorganization as defined in section 112 (g). With respect to section 112 (b) (10) reorganizations, see § 29.112 (b) (10)-1.

(a) *Purpose.* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

(b) *Scope.* (1) The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112 (b) (3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112 (b) (4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112 (g) limits the definition of the term "reorganization" to six kinds of transactions and excludes all others. From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 112 (g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in sections 112 (c) and 112 (d). Under section 112 (i) a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

(2) The provisions of the Internal Revenue Code referred to in subparagraph (1) of this paragraph are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise.

A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11050]

§ 29.112 (g)-2 *Defiinition of terms.* (a) The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

(b) The words "statutory merger or consolidation" refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

(c) In order to qualify as a "reorganization" under section 112 (g) (1) (B), the acquisition by the acquiring corporation of the required amount of the stock of the other corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation. If, for example, Corporation X exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of the required amount of stock of Corporation Y, the transaction is not a "reorganization" under section 112 (g) (1) (B).

(d) The same requirements obtain in the case of section 112 (g) (1) (C), relative to the acquisition by one corporation of substantially all the properties of another corporation, except that for the purpose of determining whether the exchange is solely for voting stock of the acquiring corperation any assumption by the acquiring corporation of liabilities of the other shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 112 (g) (1) (C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 112 (g) (1) (C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirements that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(e) A "recapitalization," and therefore a reorganization, takes place if, for example:

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

(4) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

(f) The term "a party to a reorganization" includes, in addition to a corporation which performs the specific act constituting the reorganization as described and defined in section 112 (g) (1), only a corporation specified in section 112 (g) (2). Both corporations are parties to the reorganization if under statutory authority Corporation A is merged into Corporation B; and all three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporations C and D are consolidated into Corporation E. Both corporations are parties to the reorganization if it consists of the transfer by Corporations F and G of part of the assets of Corporation F in exchange for all of the capital stock of Corporation G. Only Corporations H and J are parties to the reorganization if it consists of the acquisition by Corporation H in exchange solely for all or a part of its voting stock of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of Corporation J, even though such acquisition by Corporation H is from Corporation K.

(g) The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interest under modified corporate forms.

(h) As used in section 112, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received.

§ 29.112 (g)-3 *Exchanges solely of stock or securities, or property, solely for stock or securities, in pursuance of plan of reorganization.* No taxable income is received, nor is a deductible loss sustained, if the shareholders in a corporation a party to the following reorganization transactions exchange stock or securities solely for stock or securities of the same corporation, or of another corporation mentioned, or if one of such corporations transfers property to another of the corporations solely for stock or securities of such other corporation, in pursuance of the plan of reorganization:

(a) The merger of Corporation A, in accordance with statutory authority, into Corporation B;

(b) The consolidation, pursuant to statutory authority, of Corporations C and D into Corporation E, a new corporation;

(c) The acquisition by Corporation F, in exchange solely for all or a part of its voting stock, of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of the stock of Corporation G;

(d) The acquisition by Corporation H, in exchange solely for all or a part of its voting stock (disregarding any assumption of liabiilties, as prescribed in § 29.112 (g)-2), of substantially all the properties of Corporation I;

(e) The transfer by Corporation J of all or a part of its assets to Corporation K, if immediately after the transfer Corporation J or its stockholders, or both, are in control of Corporation K ("control" for the purpose of this transaction being defined in section 112 (h) as the ownership by Corporation J or its stockholders, or both, of the stock of Corporation K to the extent of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes thereof); or

(f) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (1) a recapitalization of a corporation, or (2) a mere change in the identity, form, or place of organization of a corporation, however effected.

§ 29.112 (g)-4 *Exchanges in reorganization for stock or securities and other property or money.* If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(a) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(b) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

Example. A, in connection with a reorganization, in 1942, exchanges a share of stock in the X Corporation purchased in 1929 at a cost of $100 for a share of stock of the Y Corporation (a party to the reorganization), which has a fair market value of $90, plus $20 in cash. The gain from the transaction

is $10 and is recognized and taxed as a gain from the exchange of property. But see section 117. However, if the share of stock received had a fair market value of $70, the loss from the transaction of $10 would not be recognized.

(c) If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized.

Example. The X Corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X Corporation in 1942 transfers all of its assets to the Y Corporation in exchange for the issues of all of the stock of the Y Corporation and the payment of $50,000 in cash to the stockholders of the X Corporation. A, who owns one share of stock in the X Corporation, for which he in 1929 paid $100, receives a share of stock in the Y Corporation worth $100 and the sum of $50 in cash in addition. A gain of $50 is recognized to A.

(d) If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to the reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, as provided in section 112 (d) (1), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized, under the provisions of section 112 (d) (2), in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 112 (e)).

(e) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (b) (3). For the proper treatment of an assumption of liabilities under section 112 (d) and so much of section 112 (e) as relates to section 112 (b) (4), see section 112 (k) and the regulations prescribed thereunder.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11050]

§ 29.112 (g)-5 *Receipt of stock or securities in reorganization without surrender of stock by shareholder.* Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, by or on behalf of a corporation a party to a reorganization, of its stock or securities (other than its own stock, which is not taxable as a dividend under section 115 (f) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (a) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (b) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings or profits shall be applied against and used to reduce the basis provided in section 113 of the stock in respect to which the distribution was made; and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. (See § 29.111-1.)

§ 29.112 (g)-6 *Records to be kept and information to be filed with returns.* (a) The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation. Each corporation a party to a reorganization shall file as a part of its return for its taxable year within which the reorganization occurred a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the reorganization, including:

(1) A certified copy of the plan of reorganization, together with a statement under oath showing in full the purposes

thereof and in detail all transactions incident to, or pursuant to, the plan.

(2) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan.

(3) A statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(4) A statement of the amount and nature of any liabilities assumed upon the exchange.

(b) Every taxpayer, other than a corporation a party to the reorganization, who receives stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization shall incorporate in his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(2) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liabilities assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

§ 29.112 (h)-1 *Control of corporation.* Section 112 (h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112 (b) (5) and section 112 (g) (1). It is provided specifically that this definition is limited to the meaning of the term "control" as that term is used in section 112.

§ 29.112 (i)-1 *Reorganization with, or transfer of property to or from, a foreign corporation.* (a) A foreign corporation will not be considered a corporation to or from which a tax-free transfer of property for stock or securities may be made, or a corporation a party to a reorganization with which a tax-free reorganization exchange may be made, or a corporation a party to or from which a tax-free liquidation distribution may be made, unless, prior to the transfer, exchange, or liquidation, it has been established to the satisfaction of the Commissioner that such transfer, exchange, or liquidation is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The term "Federal income taxes" includes (1) the excess-profits tax on the net income of a corporation referred to in section 106 of the Revenue Act of 1935, section 402 of the Revenue Act of 1936, and section 602 of the Revenue Act of 1938, (2) the declared value excess-profits tax referred to in section 600 of the Internal Revenue Code, and (3) the excess profits tax imposed by subchapter E of chapter 2 of the Code.

(b) Whether any of the exchanges or distributions referred to in section 112 (i), involving a foreign corporation, is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, is a question to be determined from the facts and circumstances of each particular case. In any such case if a taxpayer desires to establish that the exchange or distribution is not in pursuance of such a plan, a statement under oath of the facts relating to the plan under which the exchange or distribution is to be made, together with a copy of the plan, shall be forwarded to the Commissioner of Internal Revenue, Washington 25, D. C., for a ruling. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If the Commissioner determines that the exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income or excess-profits taxes, the taxpayer should retain a copy of the Commissioner's letter as authority for treating the foreign corporation as a corporation in determining the extent to which gain is recog-

nized from the exchange or distribution. If the reorganization or the transfer is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

§ 29.112 (k)-1 *Assumption of liabilities not to be taken into account for purpose of recognizing gain or loss*—(a) *General rule.* Section 112 (k) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 111 upon an exchange. Subject to the exceptions and limitations specified in paragraph (b) of this section, section 112 (k) provides, however, that:

(1) Liabilities assumed are not to be treated as "other property or money" under section 112 (e) or for the purpose of determining the amount of the realized gain which is to be recognized under section 112 (c) or (d), if the transactions would, but for the receipt of "other property or money," have been exchanges of the type described in section 112 (b) (4), (5) or (10); and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 112 (b) (4), (5) or (10) consists of an assumption of liabilities, the transaction, if otherwise qualified, shall be deemed to be within the provisions of section 112 (b) (4), (5) or (10). With respect to an exchange described in section 112 (b) (10) or so much of section 112 (d) or (e) as refers to section 112 (b) (10), the provisions of section 112 (k) shall not affect the tax liability for any taxable year beginning before January 1, 1943.

(4) The application of this paragraph may be illustrated by the following example:

Example. A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, cash in the amount of $3,000, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received	$8,000
Cash received	3,000
Liabilities assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

(5) Assuming that the transaction falls within section 112 (c) as a transaction which would have been within section 112 (b) (5) but for the receipt of "other property or money," only so much of such $5,000 gain will be recognized as does not exceed the "other property or money" received. Since section 112 (k) provides that an assumption of liabilities shall not constitute "other property or money" for this purpose, the only "other property or money" received is the $3,000 cash, and the $5,000 realized gain will be recognized only to that extent.

(b) *Exceptions and limitations.* The benefits of section 112 (k) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the amount of the liabilities assumed shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed, be treated as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as "other property or money" under section 112 (k), which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11050]

§ 29.112 (l)-1 *Exchange in connection with reorganization of insolvent corporation*—(a) *In general.* (1) Section 112 (l) and so much of section 112 (c) and (e) as relates to section 112 (l) prescribe the rules relative to the recognition of gain or loss upon certain exchanges made by the holders of stock or securities of an insolvent corporation in con-

nection with a reorganization described in section 112 (b) (10) or so much of section 112 (d) or (e) as relates to section 112 (b) (10). Under the general rule prescribed in section 112 (l) (1), no gain or loss shall be recognized if, pursuant to the plan of reorganization, stock or securities in the insolvent corporation are exchanged solely for stock or securities in the corporation organized or made use of to effectuate such plan. If, in addition to such stock or securities, other property or money is received upon such exchange, gain is recognized to the extent of such other property or money (section 112 (c)), but no loss is recognized (section 112 (e)). Section 112 (l) (2) imposes limitations upon the application of section 112 (l) (1) and so much of section 112 (c) and (e) as relates to section 112 (l) (1) in certain cases in which the exchange occurred in a taxable year beginning before January 1, 1943. As to the basis of the stock or securities or other property acquired upon an exchange under section 112 (l), see section 113 (a) (6).

(2) By thus characterizing as an exchange, and regarding as a single taxable event, the event or series of events resulting in the relinquishment or extinguishment of the stock or securities in the old corporation and the acquisition in consideration thereof, in whole or in part, of stock or securities in the new corporation, the Code secures uniformity of treatment for the participating security holders, regardless of the particular steps or the procedural devices by which such exchange is effected. Thus the transaction which qualifies as a reorganization under section 112 (b) (10) may take one of several forms. In a typical creditors' reorganization there may be a transfer of the property of the old corporation to its bondholders, or the bondholders committee, upon surrender of the bonds, followed by the transfer of such property to the new corporation in consideration of stock in the latter; or there may be a transfer of the bonds to the new corporation in exchange for its stock or securities, followed by the transfer of the property of the old corporation in consideration of the surrender of its bonds. In either event, section 112 (l) treats the result to the participating security holders as an exchange of the securities of the old corporation for securities of the new corporation. In order, however, to qualify as an exchange under section 112 (l) or so much of section 112 (c) or (e) as relates to section 112 (l) the various events resulting in the relinquishment or extinguishment of the old securities and the acquisition of the new securities must be embraced within the plan of reorganization and must be undertaken for reasons germane to the plan. If the event, or series of events, qualifies as an exchange under section 112 (l) or so much of section 112 (c) or (e) as relates to section 112 (l), no antecedent event necessarily a component of the relinquishment or extinguishment of the securities of the old corporation in consideration of the acquisition of the securities of the new corporation shall be considered a transaction or event having consequences for income or excess profits tax purposes.

(b) *Exchange solely for stock or securities.* Section 112 (l) (1) provides that no gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in an insolvent corporation described in section 112 (b) (10), or so much of section 112 (d) or (e) as relates to section 112 (b) (10), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization.

As used in section 112 (l) and this section the term security does not include a short-term note.

(c) *Exchanges for stock or securities and other property or money.* (1) If an exchange would be within section 112 (l) if it were not for the fact that the property received in the exchange consists not only of stock or securities in the corporation organized or made use of to effectuate the plan of reorganization, but also of other property or money, then:

(i) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property but

(ii) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)).

(2) If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization described in section 112 (b) (10) has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed

to each distributee as a dividend, such amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and as a gain from the exchange of property, the remainder of the gain so recognized.

(3) Consideration received in the form of an assumption of liabilities is to be treated as "other property or money" for the purposes of so much of section 112 (c) as relates to section 112 (l).

[T. D. 5402, 9 F. R. 11050]

§ 29.112 (l)-2 *Recognition of gain or loss upon exchange in taxable year beginning prior to January 1, 1943*—(a) *Final determination of tax liability prior to May 25, 1944.* (1) Section 112 (l) (2) prescribes special rules relative to the recognition of gain or loss upon an exchange described in section 112 (l) (1), or so much of section 112 (c) or (e) as relates to section 112 (l) (1), where such exchange occurred in a taxable year of a taxpayer beginning before January 1, 1943. For such purposes the statute distinguishes between cases in which there was a final determination of the tax liability prior to May 25, 1944, and cases in which there was no such final determination.

(2) Subparagraph (A) of section 112 (l) (2) provides that if an exchange described in section 112 (l) (1), or so much of section 112 (c) or (e) as relates to section 112 (l) (1), occurred in a taxable year beginning prior to January 1, 1943, and the tax liability of the taxpayer for such taxable year was finally determined prior to May 25, 1944, the recognition or nonrecognition or gain or loss upon such exchange shall be determined in accordance with the facts as to recognition or nonrecognition under such final determination. Gain or loss shall be recognized in the amount in fact recognized in such final determination. If no gain or loss was in fact recognized in such final determination, then no gain or loss shall be recognized under section 112 (l).

(3) For the purposes of this section, there is a final determination of the tax liability for a taxable year if an adjustment of the tax for such taxable year is prevented by: (1) A decision of the Board of Tax Appeals or The Tax Court, which has become final; (2) a judgment, decree, or other order by any court of competent jurisdiction, which has become final; (3) a closing agreement under section 3760; (4) a compromise under section 3761; or (5) the expiration of the period of limitations upon the assessment of a deficiency and upon the refund or credit of an overpayment.

(4) The date upon which a decision by the Board of Tax Appeals or The Tax Court becomes final is prescribed in section 1140.

(5) The date upon which the judgment of a court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States District Court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari, if no such petition is duly filed within such time.

(6) A determination under a closing agreement becomes final on the date of its approval by the Secretary, the Under Secretary, or an Assistant Secretary.

(7) A determination under a compromise becomes final upon the date of mailing to the taxpayer, or his duly authorized representative, of the notice of acceptance of the offer in compromise.

(8) For periods of limitation upon the assessment and collection of deficiencies, see sections 275 to 277, inclusive; and for periods of limitation upon the allowance of a refund or credit of an overpayment, see section 322.

(a) The fact that an adjustment in the tax liability for the taxable year may be made under a special statute of limitations, as in the case of a claim for refund under section 322 (b) (5), or under a provision such as section 734 or 3801, does not prevent a determination from becoming final within the meaning of this section.

(b) *No final determination prior to May 25, 1944.* If an exchange described in section 112 (l) (1), or so much of section 112 (c) or (e) as relates to section 112 (l) (1), occurred in a taxable year beginning prior to January 1, 1943, and the tax for such taxable year was not finally determined prior to May 25, 1944, the recognition or nonrecognition of gain or loss shall depend upon the position last maintained by the taxpayer, prior to December 15, 1943, relative to the character of such exchange as one in

which the entire amount of gain or loss is recognized or one in which all or a part of the gain or loss is not recognized. For the purposes of this section, such position must have been formally maintained by the taxpayer in his return or amended return for the taxable year, in a claim for refund, in a proceeding before a court or The Tax Court or the Board of Tax Appeals, or in some formal action taken in connection with a determination or proposed determination of his tax liability for such taxable year. If the taxpayer formally maintained that such exchange constituted a transaction upon which the entire amount of the gain or loss is recognized, then gain or loss, in the amount realized upon such exchange, shall be recognized. If the taxpayer formally maintained that such exchange constituted a transaction upon which all or a part of the gain or loss is not recognized, then gain or loss shall not be recognized except to the extent that gain is recognized under section 112 (c).
[T. D. 5402, 9 F. R. 11051]

§ 29.112 (l)-3 *Records to be kept and information to be filed.* (a) Every taxpayer who receives stock or securities and other property or money upon an exchange described in section 112 (l), or so much of section 112 (c) or (e) as relates thereto, in connection with a corporate reorganization, shall furnish a complete statement of all facts pertinent to the recognition or nonrecognition of gain or loss upon such exchange, including:

(1) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(2) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liability assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) If the exchange occurs in a taxable year beginning after December 31, 1943, the statement shall be incorporated in the taxpayer's income tax return for such taxable year. If the exchange occurred in a taxable year beginning prior to January 1, 1944, then:

(1) If the information is pertinent to the determination of the tax liability for a taxable year beginning prior to January 1, 1944, the statement shall be furnished at the time the taxpayer claims the benefit of section 112 (l), or if no such claim is made. within 30 days from the date of a request by the Commissioner or his duly authorized representative; or

(2) If the information is pertinent to the determination of the tax liability for a taxable year beginning after December 31, 1943, the statement shall be incorporated in the taxpayer's income tax return for such taxable year.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange described in section 112 (l), or so much of section 112 (c) or (e) as relates thereto, showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.
[T. D. 5402, 9 F. R. 11051]

§ 29.112 (m)-1 *Gain from sale or exchange to effectuate policies of Federal Communications Commission.* (a) Applicability only to taxable years beginning after December 31, 1942, and at the election of the taxpayer, subsection (m), in effect, postpones the recognition of gain upon the sale or exchange of property, if the Federal Communications Commission certifies such sale or exchange to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership or control of radio broadcasting stations. Any taxpayer desiring to obtain the benefits of section 112 (m) shall file with the Commissioner of Internal Revenue, or the collector of internal revenue, a certificate from the Federal Communications Commission clearly identifying the property and showing that the sale or exchange of such property is necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Such certificate shall be accompanied by a detailed statement showing: the kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property

other than money received upon such sale or exchange.

(b) Section 112 (m) applies only in the case of a sale or exchange made necessary by reason of the Commission's policies as to ownership or control of radio facilities. The section does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of subsection (m) shall be made in the manner prescribed in § 29.112 (m)-4. [T. D. 5374, 9 F. R. 5713]

§ 29.112 (m)-2 *Nature and effect of election*—(a) *Alternative elections.* (1) A taxpayer entitled to the benefits of subsection (m) in respect of a sale or exchange of property may elect:

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 112 (f); or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 112 (f), and in addition elect, except as provided in subsection (b) with respect to that portion of the gain included in a replacement fund, to reduce the basis of property, in accordance with the regulations prescribed in § 29.112 (m)-3, by all or part of the gain that would otherwise be recognized under section 112 (f); or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 29.112 (m)-3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subdivisions (i)-(iii) of this subparagraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 112 (f), including the establishment of a replacement fund, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election under section 112 (m) for any taxable year shall be irrevocable and shall be binding for such taxable year and all subsequent taxable years.

(b) *Application of sections 112 (f) and 113 (a) (9).* If the taxpayer elects, either under paragraph (a) (1) or (2) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of sections 112 (f) and 113 (a) (9), as modified by section 112 (m), together with the regulations prescribed under such sections shall be applicable to determine the amount of recognized gain and the basis of property acquired as a result of such sale or exchange. For the purposes of section 112 (m) and these regulations, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in (1) of paragraph (a) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 112 (f) and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a) (2) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a) (1) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 23 (1). Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 29.112 (m)-3.

(2) If in pursuance of an election to have the benefits of section 112 (f) the taxpayer establishes a replacement fund and the entire amount of such fund is not subsequently expended in the acquisition of property similar or related in service or use within the meaning of section 112 (f), gain shall be recognized to the extent provided in such section and the amount of such recognized gain may not be applied to reduce the basis of property under the provisions of section 112 (m) and § 29.112 (m)-3.

(3) In the application of sections 112 (f) and 113 (a) (9) to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a) (1) (i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

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

Example (1). A, who makes his returns on the calendar year basis, sold in 1943, for $100,000 cash, stock of X, a corporation which operates a radio broadcasting station. The stock had a basis in A's hands of $75,000. Forthwith, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation which also operates a radio broadcasting station. The sale was certified by the Federal Communications Commission as provided in section 112 (m) and A elected in his return for the taxable year in which the sale occurred to treat such sale and purchase as an involuntary conversion subject to the provisions of section 112 (f). He also elected at the same time to reduce the basis of depreciable property, in accordance with the provisions of § 29.112 (m)-3, by the amount of gain that would otherwise be recognized under the provisions of section 112 (f), as made applicable by section 112 (m). The determination of the amount to be applied in reduction of basis under § 29.112 (m)-3 and of the basis under section 112 (a) (9) of the stock of Y Corporation purchased by A is as follows:

Application of section 112 (f) and (m):	
Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 112 (f)	50,000
Realized gain recognized under section 112 (f) (not to exceed unexpended portion of proceeds of sale)	25,000
Amount applied in reduction of basis	25,000
Gain recognized for tax purposes	None
Application of section 113 (a) (9):	
Basis of property sold (converted)	75,000
Decreased in amount of proceeds not expended under section 112 (f)	$50,000
Balance	25,000
Increased in amount of gain recognized under section 112 (f)	25,000
Basis of Y stock in A's hands	50,000

Example (2). B, who makes his returns on the calendar year basis, owned all the stock of R Corporation, a company operating a radio broadcasting station. The stock had a basis of $100,000 in B's hands. During the calendar year 1944, B sold the R Corporation stock for $300,000, cash. The sale was certified by the Federal Communications Commission as provided in section 112 (m) and B elected in his return for the taxable year to have the benefits of section 112 (f) and applied for and received permission to establish a replacement fund with $150,000 of the proceeds of the sale. He also elected to reduce the basis of depreciable property remaining in his hands by the amount of gain that would be recognized under section 112 (f) as made applicable by section 112 (m). During the calendar year 1945, B expended $100,000 from the replacement fund to purchase stock in the S Corporation, which corporation qualifies under section 112 (m) as a corporation operating a radio broadcasting station. The balance of $50,000 in the replacement fund was withdrawn and the fund discontinued.

The computation of recognized gain, the amount to be applied in reduction of basis under § 29.112 (m)-3, and the basis in B's hands of the stock in S Corporation are as follows:

Application of section 112 (f) and (m):	
Sale price of R Corporation stock	$300,000
Basis for gain or loss	100,000
Gain realized	200,000
Proceeds of sale	300,000
Amount expended to establish replacement fund under section 112 (f)	150,000
Balance not expended in manner prescribed in section 112 (f)	150,000
Realized gain recognized under section 112 (f) (not in excess of amount not expended in establishment of replacement fund)	150,000
Amount to be applied in reduction of basis	150,000
Amount of replacement fund	150,000
Amount expended in 1945 to replace converted property	100,000
Balance (withdrawn)	50,000

Application of section 112 (f) and (m)—Con.

Amount of realized gain to be recognized for taxable year 1944	$50,000

Application of section 113 (a) (9):

Basis of R Company stock (converted)	100,000
Increased in amount of gain recognized under section 112 (f) ($50,000 recognized for tax purposes plus $150,000 applied in reduction of basis)	200,000
Total	300,000
Decreased in amount of proceeds not expended in manner prescribed in section 112 (f)	200,000
Basis of S Company stock	100,000

[T. D. 5374, 9 F. R. 5713]

§ 29.112 (m)-3 *Reduction of basis of property pursuant to election under section 112 (m)*—(a) *General rule.* In addition to the adjustments provided in section 113 (b), and the sections of these regulations relating thereto, which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 112 (m), if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 23 (l), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

The reduction of basis under section 112 (m) in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(b) *Special cases.* With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 112 (m) and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from the general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 112 (m) or, if such election is made with respect to a taxable year beginning before January 1, 1944, the request should accompany the statement of election for such year. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 3760.

[T. D. 5374, 9 F. R. 5714]

§ 29.112 (m)-4 *Manner of election.* (a) An election under the provisions of section 112 (m) shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation the statement shall be signed with the corporate name, followed by the signature and title of at least two officers of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 112 (m) to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 112 (f) may be exercised independently of each other. An election under

section 112 (m) must be filed with the return for the taxable year in which the sale or exchange occurs, except that in the case of a sale or exchange occurring in a taxable year beginning before January 1, 1944, the election must be filed with the Commissioner of Internal Revenue, Washington 25, D. C., attention of the Income Tax Unit, Records Division, on or before August 25, 1944. Where practicable, the certificate of the Federal Communications Commission required by § 29.112 (m)-1 should be filed with the election.

(b) If the taxpayer elects to treat the sale or exchange as an involuntary conversion under the provisions of section 112 (f), any application to establish a replacement fund thereunder shall be made in accordance with the provisions of such section and § 29.112 (f)-2.

(c) If, in pursuance of an election to have the basis of its property adjusted under section 112 (m), the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in the regulations, in effect at the time of filing the election, prescribed under section 112 (m), the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner of Internal Revenue to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760 of the Internal Revenue Code.

[T. D. 5374, 9 F. R. 5715]

§ 29.113 (a)-1 *Scope of basis for determining gain or loss.* The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this section and §§ 29.113 (a)-2 to 29.113 (a) (22)-1, has reference to the unadjusted basis. For special rules for determining the basis for gain or loss in the case of vessels acquired through the Maritime Commission, see sections 510 and 511 of the Merchant Marine Act of 1936, as amended. For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 127 (d).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (a)-2 *General rule.* In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in sections 113 (a) (1) to 113 (a) (22).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (a) (1)-1 *Property included in inventory.* The last inventory value of property which should be included in inventory is the basis of such property. The requirements with respect to the valuation of an inventory are stated in §§ 29.22 (c)-1 to 29.22 (d)-7.

§ 29.113 (a) (2)-1 *Property transmitted by gift after December 31, 1920*—(a) *Property included.* Section 113 (a) (2) applies to all property acquired after December 31, 1920, by gift. It does not apply:

(1) To property acquired by devise or bequest (see section 113 (a) (5)); or

(2) To property acquired by an instrument which, under section 113 (a) (5), is to be treated as though it were a will.

Section 113 (a) (2) applies to all gifts of whatever description, whenever and however made, perfected, or taking effect; whether in contemplation of or intended to take effect in possession or enjoyment at or after the donor's death; or whether made by means of the exercise (other than by will) of a power of appointment or revocation, or any other power. Section 113 (a) (2) applies whether the gift was made by a transfer in trust or otherwise.

(b) *Basis.* For the purpose of determining gain, the basis is the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift. For the purpose of determining loss, the basis is as so determined, except that in any case in which such basis, adjusted for the period prior to the date of the gift as provided in section 113 (b), is greater than the fair market value of the property at the time of the gift, the basis is such fair market value.

All titles to property acquired by gift relate back to the time of the gift, even though the interest of him who takes the title was, at the time of the gift, legal, equitable, vested, contingent, conditional, or otherwise. Accordingly, all property acquired by gift is acquired at the time of the gift. In the hands of every person acquiring property by gift, the basis is always the same, whether such person

receives the property immediately upon the transfer by the donor, or as remainderman under the instrument of gift, or or whether such person is any other person to whom such uniform basis is applicable. Such uniform basis applies to the property in the hands of the trustee or the beneficiary under a gift instrument, both during the term of the trust and after the distribution of the trust corpus. Adjustments to basis, as required by section 113 (b), are to be made as respects the period prior to the gift, and the period after the gift. With respect to the latter period, the adjustments to the uniform basis are to be made in accordance with paragraph (e) of § 29.113 (a) (5)-1.

The time of the gift is the time when the gift is consummated. Delivery, actual or constructive, is requisite to a gift. In determining the time of the gift, the passing of title by the donor is not decisive; the time when the donor relinquishes substantial dominion over the property is decisive.

(c) *Fair market value.* For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, shall be deemed to be the fair market value of the property at the time of the gift.

(d) *Reinvestments by fiduciary.* If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (b) of this section.

(e) *Records.* To insure a fair and adequate determination of the proper basis under section 113 (a) (2), persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913.

§ 29.113 (a) (3)-1 *Transfer in trust after December 31, 1920*—(a) *Property included.* Section 113 (a) (3) applies in general to all property acquired after December 31, 1920, by transfer in trust. It does not apply to property acquired by bequest or devise, by an instrument which, under section 113 (a) (5), is to be treated as through it were a will, or to property acquired as a gift by transfer in trust made at any time after December 31, 1920. With these exceptions, section 113 (a) (3) applies to all property acquired after December 31, 1920, by any transfer in trust of whatever description. If the property was acquired as a gift by transfer in trust, it is not within section 113 (a) (3), but is within section 113 (a) (2) or section 113 (a) (4).

(b) *Basis.* The basis of property so acquired is the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether prior to the termination of the trust and distribution of the property, or thereafter.

(c) *Reimbursements by fiduciary.* If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (b) of this section.

§ 29.113 (a) (4)-1 *Gift or transfer in trust prior to January 1, 1921*—(a) *Property included.* Section 113 (a) (4) applies to all property acquired before January 1, 1921, by gift or transfer in trust. It does not apply to property acquired by a devise or bequest; or by an instrument which, under section 113 (a) (5), is to be treated as though it were a will.

(b) *Basis.* The basis is the fair market value of such property at the time of the gift or at the time of the transfer in trust. Such fair market value is to be ascertained in the manner prescribed in paragraph (c) of § 29.113 (a) (2)-1, or by equivalent methods.

§ 29.113 (a) (5)-1 *Basis of property acquired by bequest, devise, or inheritance*—(a) *Property included.* Section 113 (a) (5) applies:

(1) To all property passing from a decedent by his will or under the law governing the descent and distribution of property of decedents; and

(2) To property passing under an instrument which, under section 113 (a) (5), is treated as though it were a will, but applies to such property only at the times and to the extent prescribed in section 113 (a) (5).

(b) *Basis.* Section 113 (a) (5) provides three rules for determining the basis of property transmitted at death first, a rule governing property generally, second, a special rule governing stock in a foreign personal holding company, and, third, a special rule applicable to both the first and second rules in certain cases where for estate tax purposes the decedent's gross estate is valued at the optional valuation dates.

(1) *General rule.* Except as prescribed in subparagraphs (2) and (3) of this paragraph the basis of property acquired from a decedent by will or under the law governing the descent and distribution of the property of decedents is the fair market value at the time of such acquisition. Since, under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of him who takes the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise, the time of the acquisition of such property is the death of the decedent. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property; or, if the bequest is of the residue to trustees in trust, and the executors do not distribute the residue of such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies; or, if the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died.

The purpose of the Internal Revenue Code, in prescribing a general uniform basis rule for property acquired by bequest, devise, or inheritance, is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstance that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which section 113 (a) (5) recognizes as the measure of gain or loss.

(2) *Special rule with respect to stock in a foreign personal holding company.* In the case of decedents dying after August 26, 1937, the basis of stock of a foreign corporation acquired from the decedent by will or under the law governing descent and distribution of property of decedents, where such foreign corporation with respect to its taxable year next preceding the date of the decedent's death was a foreign personal holding company, is the fair market value of such stock at the time of such acquisition, i. e., the date of the decedent's death, or the basis in the hands of the decedent (with proper adjustments to the date of the decedent's death), whichever is lower.

(3) *Special rule where property valued at optional valuation dates.* Section 113 (a) (5) provides a special rule applicable in determining the basis of property described in subparagraphs (1) and (2) of this paragraph where:

(i) Such property is includible in the gross estate of a decedent who died after October 21, 1942, and

(ii) The executor elects for estate tax purposes under section 811 (j) to value the decedent's gross estate at the optional valuation dates prescribed in such section.

In such cases, the time of acquisition of such property for the purposes of subparagraphs (1) and (2) of this para-

graph and the remainder of this section is considered to be the date at which such property is valued for estate tax purposes. Thus, in such cases, generally the basis will not be the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death or, in the case of such property distributed by the executor (or trustee, in certain cases) within one year after the decedent's death, the value as of the time of such distribution. See § 81.11 of this chapter.

(c) *Fair market value.* For the purposes of this section, the value of property as of the date of the death of the decedent as appraised for the purpose of the Federal estate tax or the optional value as appraised for such purpose, whichever is applicable as provided in paragraph (b) (3) of this section, or if the estate is not subject to such tax, its value appraised as of the date of the death of the decedent for the purpose of State inheritance or transmission taxes, shall be deemed to be its fair market value at the time of acquisition.

(d) *Property acquired before March 1, 1913; reinvestments by fiduciary.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 113 (a) (14).

If the property is an investment by the fiduciary under a will (as, for example, in the case of a sale by a fiduciary under a will of property transmitted from the decedent, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the fair market value at the time when the decedent died.

(e) *Adjustments to basis.* In the hands of every person who acquires the property of a decedent (or any estate or interest therein) by bequest, or devise, or inheritance, the basis of the property is always the same.

(1) Whether such person be the executor or administrator, the heir, the legatee, the devisee, the trustee of a trust created by the will, or any beneficiary of such trust, and whatever the nature of any such person's interest or estate may be;

(2) Whether during or after administration and settlement of the estate of the decedent, during or after the term of any trust under the will, or before or after the distribution by the executor or administrator, or the trustee.

Adjustments to basis required by section 113 (b) are made in accordance with the same principles. Thus, the deductions for depreciation and for depletion allowed or allowable, under section 23 (l) and section 23 (m), to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property in the hands not only of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under section 23 (l) and section 23 (m), both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 24 (a). Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable.

The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall make and maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by section 113 (b), and shall furnish to the Commissioner information with respect to such matters in such detail at such time and in such manner as the Commissioner may require.

(f) *Sales of remainder and other interests in property transmitted at death.* The following is an illustration of the rule stated in paragraph (b) of this section that, under section 113 (a) (5), the measure of gain or loss resulting from a sale or other disposition of property transmitted at death is the increase or decrease in the value of the property as reflected in such sale or other disposi-

tion: if land is left for life to A, with remainder in fee to B, and prior to A's death, B sells his remainder, the increase or decrease in the value of the land reflected, and realized by B, in the proceeds from the sale of his remainder interest constitutes the gain recognized upon the sale. (See section 111.) Such gain (or as the case may be, the loss) is computed by comparing the amount of the proceeds received from the sale with the amount of the part of the uniform basis assignable to such sale of B's remainder interest. The part of the uniform basis assignable to such a sale by B is the part of the uniform basis (adjusted to the time of the sale) of the land transmitted from the decedent which bears the same proportion to such uniform basis as B's remainder interest, at the time of the sale, bears to the whole estate in the land transmitted from the decedent.

§ 29.113 (a) (6)–1 *Property acquired upon a tax-free exchange.* In the case of an exchange, after February 28, 1913, of property solely of the type described in section 112 (b) or (1) if no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

If, in an exchange, after February 28, 1913, of properties of the type indicated in section 112 (b) or (1) gain to the taxpayer was recognized under the provisions of section 112 (c), (d) or (1) or a similar provision of a prior Revenue Act, on account of the receipt of money in addition in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. For example: A purchased a share of stock in the X Corporation in 1927 for $100. Pursuant to a plan of reorganization, A in 1942 exchanged his share for one share in the Y Corporation, worth $90, and $30 in cash. A realized a gain of $20 upon the exchange, all of which is recognized under section 112 (c) (1). As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the share of stock in the Y Corporation is $90; that is, the basis of the share in the X Corporation ($100) less the amount of money received by A ($30) plus the amount of gain recognized on the exchange ($20).

If, upon an exchange of properties of the type described in section 112 (b) or (1), there was received by the taxpayer in addition other property (not permitted to be received without the recognition of gain) and money, and gain from the transaction was recognized as required under section 112 (c), (d) or (1) or a similar provision of a prior Revenue Act, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

Example. A purchased a share of stock in the X Corporation in 1925 for $100. Upon a reorganization of the X Corporation in 1942, A received in place of his stoek in the X Corporation a share of stock in the Y Corporation worth $60, a Treasury bond worth $50, and in addition $20 in cash. A realized a gain of $30 upon the exchange, all of which is recognized under section 112 (c) (1). As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the property received in exchange is the basis of the old stock ($100) decreased in the amount of money received ($20) and increased in the amount of gain that was recognized ($30), which results in a basis for the property received of $100. This basis of $110 is apportioned between the Treasury bond and the share of stock, the basis of the Treasury bond being its fair market value at the date of the exchange, $50, and of the share of stock, the remainder, $60.

Section 112 (e) and similar provisions of prior Revenue Acts provide that no loss may be recognized on an exchange of properties of a type described in section 112 (b) or (1), 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, deceased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to

such other property (not permitted to be exchanged tax free) an amount of such basis equivalent to the fair market value of such other property at the date of the exchange.

Section 113 (a) (6) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. But see section 113 (a) (7) and (8).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (a) (6)-2 *Treatment of assumption of liabilities.* (a) For the purposes of section 113 (a) (6) the amount of any liabilities of the taxpayer assumed by the other party to the exchange is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, an individual, owns property having an adjusted basis of $100,000 and on which there is a purchase money mortgage of $25,000. On September 1, 1942, A organizes the X Corporation to which he transfers the property above described in exchange for all the capital stock of the X Corporation and the assumption of the $25,000 mortgage. The capital stock of the X Corporation has a fair market value of $150,000. Under section 112 (b) (5), no gain is recognized. The basis of such stock in A's hands is $75,000, computed as follows:

Adjusted basis of property transferred	$100,000
Less: Amount of money received (amount of liabilities assumed by X Corporation)	25,000
Basis of stock of the X Corporation in A's hands	75,000

Example (2). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1942, he transfers such apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage, but C does not assume such mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Since section 112 (k) does not apply to section 112 (b) (1) or so much of section 112 (c) as relates to section 112 (b) (1), $200,000 of such $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred		$500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		$300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

§ 29.113 (a) (7)-1 *Property acquired by corporation in reorganization after December 31, 1917.* (a) Section 113 (a) (7) sets forth the conditions under which the basis of property acquired by a corporation after December 31, 1917, in connection with a reorganization as defined in section 112 (g), or a corresponding provision of a prior revenue act, is the same as it would be in the hands of the transferor, increased or decreased as provided in the amount of gain or loss recognized to the transferor under the applicable revenue law. In the case of property so acquired in a taxable year beginning prior to January 1, 1936, such basis is applicable only if immediately after the transfer there remained in the same persons or any of them an interest or control in such property of 50 percent or more. In the case, however, of property so acquired in a taxable year beginning after December 31, 1935, section 113 (a) (7) is applicable irrespective of the extent of the interest or amount of control in such property remaining, immediately after the transfer, in the hands of the same persons or any of them.

(b) The application of the provisions of section 113 (a) (7) (A) may be illustrated by the following examples:

Example (1). In 1925 the X Corporation caused the organization of the Y Corporation and transferred to the Y Corporation, in exchange for all the capital stock of that corporation, property which it had previously purchased for $10,000. The basis of the property in the hands of the Y Corporation is $10,000.

Example (2). In 1925 the M Corporation exchanged 10 percent of its voting stock for all the property of the N Corporation which had a basis of $10,000 in the hands of the N Corporation. The basis of the property in the hands of the M Corporation is cost thereof to it at the time of the transfer, that is, the fair market value of the M stock exchanged for the property.

(c) Section 113 (a) (7) does not apply if, irrespective of when acquired, the property consists of stock or securities in a corporation a party to a reorganization as defined in section 112 (g), or a corresponding provision of a prior revenue act, unless such stock or securities are acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. The application of the last sentence of section 113 (a) (7) to a case where such stock or securities are acquired by the issuance of stock or securities of the transferee may be illustrated as follows:

Example (3). The Y Corporation owns all of the stock of the X Corporation, which stock it acquired in 1942 by the issuance of all of its own voting stock to the individual shareholders of the X Corporation. The stock of the X Corporation was acquired by the individuals in 1924 for $200,000 in cash. The stock of the Y Corporation had a fair market value of $1,000,000 at the time it was exchanged in 1942 for the stock of the X Corporation. The fair market value of the stock of the X Corporation at the time of the exchange in 1942 was also $1,000,000. The basis to the Y Corporation of the stock of the X Corporation is the basis which such stock would have had in the hands of the individuals from which it was acquired by the Y Corporation, that is, $200,000.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (a) (8)-1 *Property acquired by a corporation after December 31, 1920.* (a) The acquisition of property by a corporation after December 31, 1917, by the issuance of its stock or securities may not fall within the provisions of section 113 (a) (7), because of the fact that the property was not acquired in connection with a reorganization. If, however, the acquisition of such property occurred after December 31, 1920, and falls within the provisions of section 113 (a) (8), the limitations therein imposed upon the basis of such property are applicable.

(b) In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113 (a) (2).

§ 29.113 (a) (9)-1 *Property acquired as a result of an involuntary conversion.* The provisions of section 113 (a) (9) may be illustrated by the following example:

Example. A vessel purchased by A A in 1927 for $100,000 is destroyed in 1942 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

§ 29.113 (a) (10)-1 *Stocks or securities acquired in "wash sales".* The application of section 113 (a) (10) may be illustrated by the following examples:

Example (1). A purchased a share of common stock of the X Corporation for $100 in 1927, which he sold January 15, 1942, for $80. On February 1, 1942, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 118. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2). A purchased a share of common stock of the Y Corporation for $100 in 1927, which he sold January 15, 1942, for $80. On February 1, 1942, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 118. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

§ 29.113 (a) (11)-1 *Basis of property acquired during affiliation.* The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under Regulations 75 [1], Regulations 78 [1], Regulations 89 [1], Part 4 (26 CFR, 1938 ed.), Part 15 (26 CFR, 1939 Supp.) or Part 23 of this chapter, or subsequent regulations relating to consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under Regulations 75 [1], Regulations 78 [1], Regulations 89 [1], Part 4 (26 CFR, 1938 ed), Part 15 (26 CFR, 1939 Supp.) or Part 23 of this chapter, or subsequent regulations relating to consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

Except as otherwise provided in Part 23 of this chapter, the basis of property after a consolidated return period shall be the same as immediately prior to the close of such period.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5441, 10 F. R. 2425]

[1] Not filed with the Division of the Federal Register.

§ 29.113 (a) (12)-1 *Basis of property established by Revenue Act of 1932.* Section 113 (a) (1) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113 (a) (6), (7), or (9) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

If, after December 31, 1923, and in any taxable year beginning prior to January 1, 1934, in pursuance of a plan of reorganization and without the surrender of his stock, there was distributed to a shareholder in a corporation a party to the reorganization stock or securities of a corporation a party to the reorganization, then as is provided in section 113 (a) (9) of the Revenue Act of 1932, the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the new shares or securities shall be determined in accordance with the following rules:

(a) If the stock distributed in reorganization consists solely of stock in the distributing corporation and is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(b) If the stock distributed in reorganization is in whole or in part stock in a corporation a party to the reorganization other than the distributing corporation, or where the stock distributed in reorganization is in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists wholly or partly of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security

will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions, securities are different in class from stocks and stocks or securities in one corporation are different in class from stocks or securities in another corporation. In general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class.

(c) If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the identity of the lots cannot be determined, any sale of the original stock will be charged to the earliest purchases of such stock (see § 29.22 (a)-8), and any sale of the stock or securities distributed in reorganization will be resumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

(d) If the stock in respect of which a distribution in reorganization is made was purchased at different times or at different prices, and the stock or securities distributed in reorganization cannot be identified as having been distributed in respect of any particular lot of such stock, then any sale of the stock or securities distributed in reorganization will be presumed to have been made from the stock or securities distributed in respect of the earliest purchased stock.

If in any taxable year beginning after December 31, 1941, without the surrender of his stock there is acquired by a shareholder in a corporation a party to a reorganization, as a distribution in pursuance of the plan of reorganization, stock or securities in a corporation a party to the reorganization, such acquisition of new shares or securities by the shareholder will be treated as a dividend to the extent described in § 29.112 (g)-5.

§ 29.113 (a) (13)-1 *Property contributed in kind by a partner to a partnership.* The basis of property contributed in kind by a partner to partnership capital after February 28, 1913, is the cost or other basis thereof to the contributing partner. Annual allowances to the partnership for depletion and depreciation are to be computed on such basis. If such basis is greater than the fair market value of the property at the date of the transfer to the partnership, the annual depletion or depreciation allowances shall be allocated to and included in the determination of the distributive shares of the partners in accordance with their agreement in respect of the sharing of gains or losses affecting partnership capital. If the basis of such contributed property is less than the fair market value thereof at the date of transfer to the partnership, the annual allowances for depletion and depreciation are to be limited to such basis and may be apportioned among the partners according to their agreement with respect to the sharing of gains or losses affecting partnership capital. On the sale or other disposition of such contributed property by the partnership the gain or loss, determined on such transferred basis, adjusted as required by section 113 (b), shall be prorated in determining the distributive shares of the partners according to their gain or loss ratios on the disposition of a partnership asset under the partnership agreement.

§ 29.113 (a) (13)-2 *Readjustment of partnership interests.* (a) When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost or other basis as hereinbefore provided and the value of such interest as of such date, plus the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in § 29.111-1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

(b) If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

§ 29.113 (a) (14)-1 *Property acquired prior to March 1, 1913.* (a) 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.

(b) The basis as of March 1, 1913, for determining loss in the case of property acquired prior to that date is the cost or other basis provided for such property under section 113 (a) adjusted as required by section 113 (b), but without reference to the fair market value of the property as of March 1, 1913. However, see sections 117 (k) (1) and 117 (k) (2) with respect to the determination of loss upon timber which under the provisions of those sections is considered to be sold or exchanged.

Example. A, who makes his returns upon the calendar year basis, in 1908 purchased property for $100,000. Assuming, for the purposes of this example, that there are no additions and betterments to be taken into account, the depreciation sustained on the property prior to March 1, 1913, was $10,000, so that the original cost adjusted as of March 1, 1913, for depreciation sustained prior to that date was $90,000. As of that date the fair market value of the property was $94,000. (*a*) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1942, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If it be assumed that the amount of depreciation deductions allowed (not less than the amount allowable) after February 28, 1913, to the year 1942 is in the aggregate sum of $43,240, the adjusted basis for determining gain in 1942 ($94,000 less $43,240) is $50,760. (*b*) For the purpose of determining a loss from the sale or other disposition of such property in 1942, the basis of the property is the cost of the property, without reference to the fair market value as of March 1, 1913, adjusted for depreciation before March 1, 1913, and after February 28, 1913. The amount of depreciation sustained prior to March 1, 1913, in this example is $10,000, and if the amount of depreciation to be accounted for after February 28, 1913, is assumed to be $43,240, the aggregate amount of depreciation for which adjustment of such cost must be made is $53,240. The adjusted basis for determining the loss in 1942 ($100,000 less $53,240) is $46,760.

(c) What the fair market value of property was on March 1, 1913, is a question of fact to be established by competent evidence. In determining the fair market value of stock in a corporation, due regard shall be given to the fair market value of the corporate assets on such date. In the case of property traded in on public exchanges, actual sales at or about the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced sale price or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time, but such value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in every case.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5394, 9 F. R. 9136]

§ 29.113 (a) (15)-1 *Basis of property received by a corporation in complete liquidation of another corporation.* Except as otherwise provided in this section, the basis of property received in complete liquidation, without the recognition of gain or loss as provided in section 112 (b) (6), shall be the same as the basis of the property in the hands of the liquidating corporation with proper adjustments as provided in section 113. See section 113 (b).

In the case of property received in liquidation after December 31, 1935, and before June 23, 1936, in a taxable year of the recipient corporation beginning after December 31, 1935, the basis of such property in the hands of the recipient corporation shall be the basis prescribed by section 113 (a) (6) of the Revenue Act of 1934, as amended by the Revenue Act of 1935, if:

(a) Such property was received in a liquidation which was completed before June 23, 1936;

(b) Such liquidation constituted a complete liquidation within the meaning of section 112 (b) (6) of the Revenue Act of 1934, as added by the Revenue Act of 1935;

(c) No gain or loss would have been recognized under section 112 (b) (6) of the Revenue Act of 1934, as amended, upon the receipt of such property; and

(d) The recipient corporation (within 180 days after the enactment of the Revenue Act of 1938), under regulations prescribed under section 808 of the Revenue Act of 1938 (26 CFR, 1938 Ed., 3.113 (a) (15)-1, as amended by T. D. 4815, 3 F. R. 1466), 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.

§ 29.113 (a) (16)-1 *Basis of property established by Revenue Act of 1934.* Section 113 (a) (16) provides that if property was acquired after February 28, 1913, in any taxable year beginning prior to January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113 (a) (6), (7), or (8) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed under the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning prior to January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112 (b) (5) of the Code but which is described in section 112 (b) (5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 29.113 (a) (18)-1 *Basis of property received in certain corporate liquidations*—(a) *Property included.* Section 113 (a) (18) applies only to property, other than money, acquired:

(1) By a qualified electing shareholder;

(2) Upon a distribution in complete liquidation of a domestic corporation

(i) Pursuant to a plan of liquidation adopted after May 28, 1938, in accordance with which the distribution is in complete cancellation or redemption of all the stock and the transfer of all the property in the liquidation occurs within the month of December, 1938, or

(ii) Pursuant to a plan of liquidation adopted after February 25, 1944, in accordance with which the distribution is in complete cancellation or redemption of all the stock and the transfer of all the property in the liquidation occurs within some one calendar month of the calendar year 1944; and

(3) In cancellation or redemption of only those shares of stock which were owned by such qualified electing shareholder at the time of the adoption of the plan of liquidation and on which he realizes gain.

It applies to all the property, except money, so acquired, though such property may consist in whole or in part of stock or securities acquired by the liquidating corporation after April 9, 1938, if subdivision (i) is applicable, or after December 10, 1943, if subdivision (ii) is applicable.

(b) *Basis.* The basis of such property so acquired is the same as the basis of the shares of stock, in cancellation or redemption of which such property was received, with proper adjustments to the date of acquisition, decreased in the amount of such shares' ratable share of any money received in cancellation or redemption of shares of the same class, and increased in the amount of gain recognized under the provisions of section 112 (b) (7) of the Revenue Act of 1938, or section 112 (b) (7) of the Internal Revenue Code, as the case may be. If such property consists of more than one class of property, the basis shall be allocated among the several properties (other than money) acquired in the proportion that the fair market value of each such property as of the date of acquisition bears to the fair market value of all such properties on that date. The application of this subsection may be illustrated by the following example:

Example. The X Corporation distributed all its property in complete liquidation during the month of October 1944, pursuant to the provisions of section 112 (b) (7) of the Code. A, an individual and a qualified electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him at the time of the adoption of the plan of liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after December 10, 1943) with a fair market value of $12,000, and stock acquired by the liquidating corporation after December 10, 1943, with a fair market value of $4,000. The basis of the shares owned by A was $100 per share, or $10,000. A's ratable share of the earnings and profits of the X Corporation accumulated after February 28, 1913 (computed as provided in section 112 (b) (7) of the Code) was $2,500. His gain is $7,000, but under section 112 (b) (7) of the Code only $5,000 of this gain is recognized, $2,500 thereof being taxed as a dividend. The basis of all the property other than money received by A is $14,000, computed as follows:

Adjusted basis of stock canceled or redeemed	$10,000
Less money received	1,000
Remainder	9,000
Plus gain recognized	5,000
Basis of property acquired	14,000

This basis will be apportioned among the classes of property (other than money) received as follows: 12,000/16,000 of $14,000, or $10,500, to the property other than stock; 4,000/16,000 of $14,000, or $3,500, to the stock.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5356, 9 F. R. 4325]

§ 29.113 (a) (19)-1 *Basis of stock and rights involved in the acquisition of stock dividends or stock rights; general rules*—(a) *Stock dividends.* In the case of stock in respect of which was acquired a stock dividend of any character in a taxable year beginning before January 1, 1936, or in respect of which was acquired in a taxable year beginning after December 31, 1935, a stock dividend which did not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made or the stock dividend shall (except as otherwise prescribed in § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 29.113 (a) (12)-1.

(b) *Stock rights acquired after December 31, 1924.* In the case of stock in respect of which were acquired after December 31, 1924, and before the first day of the first taxable year beginning after December 31, 1935, stock subscription rights (whether or not constituting income to the shareholder within the meaning of the sixteenth amendment to the Constitution) or in respect of which were acquired in a taxable year beginning after December 31, 1935, stock subscription rights which did not constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution, and in the case of such rights, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made, or the subscription rights distributed, or the stock acquired in the exercise of such rights shall (except as otherwise prescribed in § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in § 29.22 (a)-8.

(c) *Stock rights acquired before January 1, 1925.* In the case of stock in respect of which were acquired prior to January 1, 1925, stock subscription rights (whether or not constituting income to the shareholder within the meaning of the sixteenth amendment to the Constitution), and in the case of such rights, the basis for determining gain or loss from a sale or other disposition of either the stock in respect of which the distribution was made, or the subscription rights distributed, or the stock acquired in the exercise of such rights shall (except as otherwise prescribed in § 29.113 (a) (19)-2) be ascertained in accordance with the principles set forth in article 39 of Regulations 65.

§ 29.113 (a) (19)-2 *Exceptions to general rules*—(a) *Proceeds of sale of rights reported as income.* In the case of stock rights sold in a taxable year beginning prior to January 1, 1939, the general rules for ascertaining the basis for determining gain or loss set forth in paragraphs (b) and (c) of § 29.113 (a) (19)-1, and in § 29.22 (a)-8 or article 39 of Regulations 65, as the case may be, shall not apply if the entire proceeds of such sale were included by the taxpayer as gross income for the year of the sale and if, befor June 29, 1939, the taxpayer had not asserted by a claim for a refund or credit or otherwise that any part of such proceeds should not have been included in gross income for the year of the sale. In such cases, the basis for determining gain or loss from a subsequent sale or other disposition of the stock in

respect of which the rights were acquired shall be the same as though the rights had not been acquired.

(b) *Receipt of stock dividend or stock right reported as income in prior years.* In the case of stock dividends or stock rights acquired in a taxable year beginning prior to January 1, 1936, the general rules for ascertaining the basis for determining gain or loss set forth in § 29.113 (a) (19)-1, and in §§ 29.113 (a) (12)-1, 29.22 (a)-8, or article 39 of Regulations 65, as the case may be, shall not apply if for any reason there was included in the gross income of the shareholder as a dividend for such year, as, for example, pursuant to the provisions of section 201 (c) of the Revenue Act of 1918 or the corresponding provisions of prior Revenue Acts, or as a result of the decision of the Supreme Court in Koshland *v.* Helvering (298 U. S. 441), an amount reflecting the acquisition of such stock dividend or stock rights, and if before June 29, 1939, such amount was not excluded from gross income for such year. In such cases, the basis for determining gain or loss with respect to the old stock shall be the same as though the stock dividends or the stock rights had not been acquired, and the basis with respect to the stock dividend or stock right shall be an amount equal to that at which such stock dividend or stock right was included in gross income for the year of its acquisition.

(c) *Gain or loss upon sale of old or new stock finally determined upon basis inconsistent with general rules.* The general rules for ascertaining the basis for determining gain or loss set forth in § 29.113 (a) (19)-1 shall not apply with respect to the old stock, the new stock, or the subscription rights to acquire new stock, remaining on hand after a sale or other disposition of old stock, subscription rights, or new stock effected in a taxable year beginning prior to January 1, 1936, if the basis for determining gain or loss on such sale or other disposition was fixed by a decision of a court or The Tax Court of the United States or by a closing agreement, and if such decision or closing agreement became final on or before September 26, 1939, and if the basis for determining gain or loss upon such sale or other disposition was fixed by a method other than that of allocation of basis provided by the general rule. In such cases, the basis for determining gain or loss with respect to the remaining shares shall be fixed in a manner consistent with the prior determination to the end that, the sale or other disposition of all lots being considered, the taxpayer will have effected ultimately a tax-free recovery of the total cost or other basis of his original shares, and no more.

§ 29.113 (a) (20)-1 *Property acquired by railroad corporation in a receivership or bankruptcy proceeding.* (a) Section 113 (a) (20) sets forth certain conditions under which the basis of property acquired by a railroad corporation is the same as it would have been in the hands of the railroad corporation whose property was acquired. For the purpose of section 113 (a) (20), it is unnecessary that the acquisition in question be a direct transfer from the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 112 (g). It is sufficient if the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding.

(b) If the conditions of section 113 (a) (20) are satisfied, then for the purpose of determining basis, the provisions of section 113 (a) (20) only shall apply, notwithstanding that the transaction might also fall within another provision of section 113 (a).

§ 29.113 (a) (21)-1 *Property acquired by electric railway corporation in bankruptcy proceeding.* Subject to the limitations and conditions set forth in section 113 (a) (21), if the reorganization under section 77B of the National Bankruptcy Act, as amended, of an electric railway corporation results in the acquisition of the property of such corporation by another corporate entity, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the old corporation. It is requisite to the application of the section that both corporations be street, suburban, or interurban electric railway corporations engaged in the transportation of persons or property in interstate commerce, and that the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding. If section 113 (a) (21) applies, section 270 of Chapter X of the National Bankruptcy Act, as

amended, relating to the adjustment of basis by reason of the cancellation or reduction of indebtedness in a bankruptcy proceeding, is inapplicable. Moreover, if the transaction is within the provisions of section 113 (a) (21) and may also be considered to be within any other provision of section 113 (a), then the provisions of section 113 (a) (21) only shall apply.

§ 29.113 (a) (22)-1 *Basis of property acquired by corporation as result of certain bankruptcy or receivership proceedings.* (a) If, as the result of a transaction described in section 112 (b) (10), or so much of section 112 (d) or (e) as relates thereto, the property of an insolvent corporation is transferred, in pursuance of a plan of reorganization, to a corporation organized or made use of to effectuate such plan, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the insolvent corporation, increased in the amount of gain recognized upon such transfer under the law applicable to the year in which the transfer was made. In any such case, the adjustments to basis provided by section 270 of the National Bankruptcy Act, as amended, or section 113 (b) (3) of the Code, shall not be made in respect of any indebtedness cancelled pursuant to the plan of reorganization under which the transfer was made. If the transaction falls within the provisions of section 113 (a) (22), the basis of the property involved shall be determined pursuant to such provisions, notwithstanding that the transaction might otherwise fall within another provision of section 113 (a).

(b) The provisions of section 113 (a) (22) are applicable in the determination of basis for all taxable years beginning after December 31, 1933, except that the basis so determined shall not be given effect in the determination of the tax liability for any taxable year beginning prior to January 1, 1943. With the exception indicated, the basis so prescribed is applicable both for income and excess profits tax purposes from the date of acquisition of such property.

(c) For example, the provisions of section 113 (b) relating to adjusted basis shall be applied as if section 113 (a) (22) were a part of the Internal Revenue Code and prior revenue laws applicable to all taxable years beginning after December 31, 1933. Hence, in determining the amount of the adjustments for depreciation, depletion, etc., under the provisions of section 113 (b) (1) (B), the amount allowable is the amount computed with reference to the basis provided in section 113 (a) (22).

Example (1). On January 1, 1935, the Y Corporation, a taxpayer making its returns on the calendar year basis, acquired depreciable property from the X Corporation as the result of a transaction described in section 113 (a) (22). On January 1, 1935, the property had, in the hands of the X Corporation, a basis of $200,000, an adjusted basis of $150,000, a fair market value as of January 1, 1935, of $80,000, and an estimated remaining life of 20 years. The 1935 transaction was treated as a taxable exchange and, accordingly, the Y Corporation claimed and was allowed depreciation in the amount of $4,000 for each of the nine taxable years 1935 through 1943, inclusive. On June 30, 1944, the property was sold for $40,000, cash. The amount of the loss sustained upon the sale is computed as follows:

Basis to Y Corporation (section 113 (a) (22))		$200,000
Adjustment for depreciation in the hands of X Corporation (section 113 (b))		50,000
Adjusted basis for depreciation in the hands of Y Corporation		150,000
Deduct:		
Depreciation allowable in amount of $7,500 per year (1/20 of $150,000) for eight years, from January 1, 1935, through December 31, 1942	$60,000	
Depreciation allowable January 1, 1943 to June 30, 1944 ($1\frac{1}{2}$ years at $7,500)	11,250	
		71,250
Adjusted basis for computing gain or loss		78,750
Sale price		40,000
Loss sustained		38,750

For the taxable years 1943 and 1944, the Y Corporation is entitled to deductions for depreciation in respect of such property in the amounts of $7,500 and $3,750, respectively, in the determination of its tax liabilities for such years. But no change in the tax liability is authorized for preceding taxable years by reason of the difference between the $7,500 depreciation allowable and the $4,000 deduction previously allowed.

Example (2). Assume the same facts as in example (1), except that the property acquired by the Y Corporation had a fair market value as of January 1, 1935, of $180,000, instead of $30,000, and that the Y Corporation claimed and was allowed depreciation

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in the amount of $9,000 for each of the 8 taxable years 1935 to 1942, inclusive, and in the amount of $7,500 for the taxable year 1943. In such case, the amount of the loss sustained upon the sale of the property would be computed as follows:

Adjusted basis for depreciation in the hands of Y Corporation as computed in example (1)		$150,000
Deduct:		
(1) Depreciation allowed in the amount of $9,000 per year for eight years, January 1, 1935 to December 31, 1942	$72,000	
(2) Depreciation allowable for taxable years 1943 and 1944 (1½ times $6,500)	9,750	
		81,750
Adjusted basis for computing gain or loss		68,250
Sale price		40,000
Loss sustained		28,250

No change in the tax liability is authorized for taxable years preceding 1943 by reason of the difference between the $7,000 depreciation allowable and the $9,000 deduction previously allowed.

[T. D. 5402, 9 F. R. 11052, as amended by T. D. 5433, 10 F. R. 1127, T. D. 5458, 10 F. R. 7335]

§ 29.113 (b) (1)-1 *Adjusted basis; general rule.* (a) The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113 (a) (1) to (22), inclusive, the basis therein provided, adjusted to the extent provided in section 113 (b).

(b) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. In the case of mines and oil or gas wells the following shall not be considered as items properly chargeable to capital account: (1) Expenditures made in the taxable year 1932 or subsequent taxable years which are allowable under article 235 or 236 of Regulations 77, article 23 (m)-15 or 23 (m)-16 of Regulations 86, 26 CFR, 1938 ed., 3.23 (m)-15 or 3.23 (m)-16, 26 CFR, 1939 Supp., 9.23 (m)-15 or 9.23 (m)-16, 26 CFR, 1940 Supp., 19.23 (m)-15 and 19.23 (m)-16, and §§ 29.23 (m)-15 or 29.23 (m)-16 of these regulations as deductions in computing net income; (2) expenditures made in taxable years prior to 1932 which were allowed, or which may hereafter be allowed, as deductions in computing the net income of the taxpayer for such taxable years.

Example. A, who makes his returns on the calendar year basis, puhchased property in 1933 for $10,000. H subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1942 for $20,000, the amount of his gain will be $4,000. As to the amount of such gain to be taken into account in computing net income, see section 117.

(c) Capital expenditures and carrying charges with respect to property, whether real or personal, improved or unimproved and whether productive or unproductive, such as taxes and interest, as to which under these regulations there is an election to treat either as chargeable to capital account or as an allowable deduction in the manner provided in § 29.24-5 (c) but for which there have been taken no deductions by the taxpayer in determining net income for the taxable year, or a prior taxable year, are properly chargeable to capital account. (See § 29.24-5.) The term "taxes" for this purpose includes duties and excise taxes (see § 29.23 (c)-2), but does not include income taxes.

(d) The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolence, amortization, and depletion to the extent such deductions have in respect to any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. For example, the case

of Corporation A discloses the following facts as of January 1, 1942:

Year	Allowed	Allowable	Allowed, but not less than amount allowable
1935	$6,000	$5,000	$6,000
1936	7,000	6,500	7,000
1937	6,500	6,500	6,500
1938	6,500	6,000	6,500
1939	5,000	6,000	6,000
1940	4,500	6,000	6,000
1941	4,000	6,000	6,000
	39,500	42,000	44,000

(e) The depreciation allowed but not less than the amount allowable in this example as of January 1, 1942, is $44,000, and the cost or other basis of the property is to be adjusted by that amount. The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114 (b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, the Revenue Act of 1938, and the Internal Revenue Code, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

(f) The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depletion sustained in respect of any period prior to March 1, 1913.

(g) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue act of 1918 or 1921).

Example. A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated prior to March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1942 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition. But see section 117.

(h) In the case of the stock of United States shareholders in a foreign personal holding company the cost or other basis must be adjusted also to the extent provided in section 337 (f).

(i) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(j) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Internal Revenue Code. For adjustment to basis of bonds on account of amortizable bond premium, see §§ 29.125-1 to 29.125-9.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (b) (1)-2 *Adjusted basis; cancellation of indebtedness.* In addition to the adjustments provided in section 113 (b) (1) and § 29.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment is required in certain cases in which there has been a cancellation or reduction of indebtedness in a proceeding under the Bankruptcy Act, as amended. Except as otherwise provided in section 113 (a) (21) or (22), or 113 (b) (4), such further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner", as defined in the Bankruptcy Act, as amended), or 77B or under Chapter X, XI, XII of the Bankruptcy Act of 1898, as amended. Such further adjustment shall be made in the following manner and order:

(a) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable) whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any

such proceeding, the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(b) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(c) Any excess of the total amount by which the indebtedness shall have been so cancelled or reduced in such proceeding over the sum of the adjustments made under paragraphs (a) and (b) of this section shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by paragraphs (a) and (b) of this section) as follows: The cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under paragraphs (a) and (b) of this section) of each such unit of property bears to the sum of the adjusted bases (after adjustment under paragraphs (a) and (b) of this section) of all the property of the debtor other than inventory and notes and accounts receivable;

(d) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under paragraphs (a), and (b), and (c) of this section shall next be applied to reduce the cost or other basis of any units of property covered by paragraphs (a), (b), and (c) of this section which have a remaining basis (after adjustment under paragraphs (a), (b), and (c) of this section) greater than their fair market value, as follows: The cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining bases of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by paragraphs (a), (b), and (c) of this section is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(e) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under paragraphs (a), (b), (c), and (d) of this section shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable. The process shall be repeated until the adjusted bases of inventory, notes receivable and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

(f) For the purposes of this section:

(1) Basis shall be determined as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(2) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(3) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(4) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(5) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced.

(g) Any determination of value in a proceeding under the Bankruptcy Act, as amended, shall not constitute a determination of fair market value for the purposes of this section.

(h) The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this section.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11052]

§ 29.113 (b) (1)-3 *Adjusted basis; cancellation of indebtedness; special cases.* If the taxpayer and the Commissioner agree, the basis of the taxpayer's property may be adjusted in a manner different from that set forth in § 29.113 (b) (1)-2. Variations from such rule may, for example, involve adjusting the basis of any part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation. Agreement between the taxpayer and the Commissioner as to any variation from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760.

§ 29.113 (b) (2)-1 *Substituted basis.* Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2), the adjustments indicated in § 29.113 (b) (1)-1 shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 113 (b) (2) (A), the adjustments indicated in §§ 29.113 (b) (1)-2, 29.113 (b) (3)-1, and 29.113 (b) (3)-2 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

Example. A, who makes his returns upon the calendar year basis, in 1927 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or other disposition of the Y Building in 1942, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 29.113 (b) (3)-1 *Adjusted basis; discharge of corporate indebtedness; general rule.* In addition to the adjustments provided in section 112 (b) (1) and § 29.113 (b) (1)-1 which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 113 (a) (21) or (22), or 113 (b) (4), a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 22 (b) (9) on account of the discharge of indebtedness of a corporation during the taxable year. Such further adjustment shall, except as otherwise provided in § 29.113 (b) (3)-2, be made in the following manner and order:

(a) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been discharged, the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) by an amount equal to the amount excluded from gross income under section 22 (b) (9) and attributable to the discharge of the indebtedness so incurred with respect to such property;

(b) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such

property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) by an amount equal to the amount excluded from gross income under section 22 (b) (9) and attributable to the discharge of the indebtedness secured by such lien;

(c) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under paragraphs (a) and (b) of this section shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by paragraphs (a) and (b) of this section) as follows: The cost or other basis of each unit of property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable; and

(d) Any excess of the total amount excluded from gross income under section 22 (b) (9) over the sum of the adjustments made under paragraphs (a), (b), and (c) of this section shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable.

(e) For the purposes of this section:

(1) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(2) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay;

(3) The phrase "amount excluded from gross income under section 22 (b) (9)" means the amount of income excluded under that section reduced by any deduction disallowed under that section for unamortized discount;

(4) Adjustments to basis shall be made:

(i) In the case of property owned on the first day of the taxable year, as of that day;

(ii) In the case of property acquired after the first day of the taxable year, as of the day so acquired;

regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(6) Regardless of the amount excluded by the taxpayer from its gross income under section 22 (b) (9) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness.

Example (1). On January 1, 1942, the N Corporation owned an office building, which it sold in March 1942. In June 1942 it purchased a factory building. In October 1942 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 22 (b) (9), the basis of each building shall be adjusted under section 113 (b) (3) for the taxable year 1942. (But see § 29.113 (b) (3)-2.)

Example (2). The M Corporation has outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1942 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount is $50.

If the M Corporation under section 22 (b) (9) elects to have excluded from gross income the amount of income attributable to the discharge of both bond issues, the total

reduction in basis of the property of the M Corporation shall not exceed $2,150. If the M Corporation elects only with respect to the A bonds, the total reduction in basis shall not exceed $1,200 (or $950 if the election is with respect to the B bonds). If the M Corporation excludes only an amount of $500 with respect to the A bonds, the total reduction in basis may nevertheless be $1,200 (or $950 if the exclusion is with respect to the B bonds).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5402, 9 F. R. 11053]

§ 29.113 (b) (3)-2 *Adjusted basis; discharge of corporate indebtedness; special cases.* (a) Section 29.113 (b) (3)-1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under section 22 (b) (9). The taxpayer may, however, have the basis of its property adjusted in a manner different from that set forth in § 29.113 (b) (3)-1 upon a proper showing to the satisfaction of the Commissioner. Variations from such general rule may, for example, involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

(b) A request for variations from the general rule prescribed in § 29.113 (b) (3)-1 should be filed by the taxpayer with its return for the taxable year in which the discharge of indebtedness has occurred. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effected only by a closing agreement entered into under the provisions of section 3760. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in § 29.113 (b) (3)-1, then the consent filed on Form 982 shall be deemed to be a consent to the application of such general rule and such general rule shall prevail in the determination of the basis of the taxpayer's property, unless the taxpayer specifically states on such form that it does not consent to the application of the general rule.

§ 29.113 (b) (4)-1 *Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.* The adjustment to basis provided by section 270 of the Bankruptcy Act of 1898, as amended, and §§ 29.113 (b) (1)-2 and 29.113 (b) (1)-3 shall not be made if, in a proceeding under section 77B of such act, indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered prior to September 22, 1938. Section 113 (b) (4) and this section do not apply if the plan of reorganization under section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

[T. D. 5370, 9 F. R. 5110]

§ 29.113 (c)-1 *Property on which lessee has made improvements.* In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 22 (b) (11), would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning prior to January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. In 1942 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, both years inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by

the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see section 117.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5600, 13 F. R. 577]

§ 29.114-1 *Basis for allowance of depreciation and depletion.* The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other desposition of such property, except that as provided in § 29.23 (m)-21 in the case of the cutting of timber which is considered to be a sale or exchange of such timber under section 117 (k) (1), the basis shall be the fair market value of such timber as of the first day of the taxable year in which it is cut, and except as provided in § 29.23 (m)-3, relating to depletion based on discovery value, in § 29.23 (m)-4, relating to percentage depletion in the case of oil and gas wells, and in § 29.23 (m)-5, relating to percentage depletion in the case of coal mines, metal mines, fluorspar mines, ball and sagger clay mines, or rock asphalt mines, and sulphur mines or deposits with respect to taxable years beginning after December 31, 1941, in the case of flake graphite mines with respect to taxable years beginning after December 31, 1942, in the case of vermiculite, beryl, feldspar, mica, talc (not including pyrophyllite), lepidolite, spodumene, and barite mines, and potash mines or deposits (including potash salts in solution) with respect to taxable years beginning after December 31, 1943, and in the case of bauxite, pyrophyllite, china clay, and phosphate rock mines, and trona, bentonite, gilsonite, and thenardite (from brines and mixtures of brine) mines or deposits for taxable years beginning after December 31, 1946.

[T. D. 5645, 13 F. R. 4257]

§ 29.115-1 *Dividends.* (a) The term "dividend" for the purpose of chapter 1 (except when used in section 201 (c) (5), section 204 (c) (11), and section 207 (a) (2) and (b) (3) where the reference is to dividends of insurance companies paid to policyholders) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either:

(1) Earnings or profits accumulated since February 28, 1913, or

(2) Earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

(b) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 504 (c), relating to dividends paid within 2½ months after the close of the taxable year, or section 506, relating to deficiency dividends, or corresponding provisions of a prior income-tax law, was under the applicable law a personal holding company, the term "dividend", in addition to the meaning set forth in the first sentence of section 115 (a), also means the following distributions to its shareholders:

(1) A distribution within a taxable year of the corporation, and of a shareholder, both of which taxable years begin prior to January 1, 1944, is a dividend (except as hereinafter indicated) to the extent of the corporation's subchapter A net income for the taxable year in which, or, in the case of a distribution under section 504 (c) or section 506, the taxable year in respect of which, the distribution is made.

(2) A distribution within a taxable year of the corporation, or of a shareholder, where either taxable year begins after December 31, 1943, is a dividend to the extent of the corporation's subchapter A net income less the sum of the net operating loss credit provided in section 26 (c) (1), the dividend carry-over provided in section 27 (c), and the deduction for amounts for retirement of indebtedness provided in section 504 (b), for the taxable year in which, or, in the case of a

distribution under section 504 (c) or section 506, the taxable year in respect of which, the distribution is made. Thus, in the case of a distribution in April, 1944, by a corporation reporting on a calendar year basis to a shareholder reporting on the basis of a fiscal year ending June 30, 1944, the taxable year of the corporation begins after December 31, 1943, and the April, 1944, distribution is a dividend, in the case of the corporation and the shareholder alike, only to the extent of the corporation's subchapter A net income reduced by the specified credits. Similarly, in the case of a distribution in April, 1944, by a corporation reporting on the basis of a fiscal year ending June 30, 1944, to a shareholder reporting on the calendar year basis, the taxable year of the shareholder begins after December 31, 1943, and the April, 1944, distribution will constitute a dividend, in the case of the corporation and the shareholder alike, only to the extent of the corporation's subchapter A net income reduced by the specified credits.

(c) No interest shall be allowed or paid in respect of any overpayment of tax resulting from the amendment to section 115 (a) made by Public Law 113 (80th Congress). For treatment of any distribution made prior to October 21, 1942, which is a dividend solely by reason of the last sentence of section 115 (a) prior to its amendment by Public Law 113, see § 29.504-3.

(d) The term "dividend" does not include distributions under section 115 (c), relating to distributions in liquidation, section 115 (e), relating to distributions by personal service corporations, or section 115 (f), relating to stock dividends, or certain distributions by insurance companies (see section 115 (a)). In all other cases the term includes any distribution to shareholders to the extent made out of accumulated or current earnings or profits.

(e) A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

(f) The application of section 115 (a) may be illustrated by the following examples:

Example (1). At the beginning of the calendar year 1942, the M Corporation had an operating deficit of $200,000 and the earnings or profits for the year amounted to $100,000. Beginning on March 16, 1942, the corporation made quarterly distributions during the taxable year to its shareholders of $25,000 each. Each distribution is a taxable dividend in full, irrespective of the actual or the pro rata amount of the earnings or profits on hand at any of the dates of distribution, since the total distributions made during the year ($100,000) did not exceed the total earnings or profits of the year ($100,000).

Example (2). At the beginning of the calendar year 1942 the N Corporation, a personal holding company, had no accumulated earnings or profits. During that year it made no earnings or profits but its subchapter A net income, due to the disallowance of certain deductions, was $16,000. It distributed to shareholders on December 15, 1942, $15,000 and on February 1, 1943, $1,000, the latter amount being claimed as a deduction under section 504 (c) in its personal holding company return for 1942 filed on March 15, 1943. Both distributions are taxable dividends in full, since they do not exceed the subchapter A net income for 1942, the taxable year in which the distribution of $15,0000 was made and with respect to which the distribution of $1,000 was made. It is immaterial whether the N Corporation is a personal holding company for the taxable year 1943 or whether it had any income for that year.

Example (3). In 1944, a deficiency in personal holding company tax was established against the O Corporation for the taxable year 1940 in the amount of $34,430 based on an undistributed subchapter A net income of $42,000 which consisted of a subchapter A net income of $52,000 minus a deduction of $10,000 for amounts used for retirement of indebtedness provided in section 504 (b). The O Corporation complied with the provisions of section 506 and in December 1944 distributed $42,000 to its stockholders as "deficiency dividends". The distribution of $42,000 is a taxable dividend since it does not exceed $42,000 (subchapter A net income of $52,000 for 1940, the taxable year with respect to which the distribution was made, minus the deduction for retirement of indebtedness of $10,000). It is immaterial whether the O Corporation is a personal holding company for the taxable year 1944 or whether it had any income for that year.

Example (4). At the beginning of the taxable year 1946, the P Corporation, a personal holding company, had a deficit in earnings and profits of $200,000. During that year it made earnings and profits of $55,000. For that year, however, it had a subchapter A net income of $100,000, a net operating loss credit under section 26 (c) (1) of $10,000 and a deduction for retirement of indebtedness under section 504 (b) of $10,000. During such taxable year it distributed to its shareholders $100,000. The distribution of $100,000 is a taxable dividend to the extent of $80,000 (subchapter A net income of $100,000 minus the net operating loss credit of $10,000 and the deduction for retirement of indebtedness of $10,000). No

interest shall be allowed or paid in respect of any overpayment of tax resulting from the inclusion in taxable income by any shareholder of his proportionate share of the distribution of $100,000.

Example (5). If the facts were the same as in example (4) except that the P Corporation had earnings and profits for the taxable year 1946 of $90,000, the distribution of $100,000 would be a taxable dividend to the extent of $90,000 since its earnings and profits for that year, $90,000, exceed $80,000 (subchapter A net income of $100,000 minus the net operating loss credit of $10,000 and the deduction for retirement of indebtedness of $10,000).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5377, 9 F. R. 6252, T. D. 5670, 13 F. R. 6882]

§ 29.115-2 *Sources of distributions in general.* (a) For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given first, to the earnings or profits of the taxable year; second, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; third, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings or profits only after the earnings or profits have been distributed.

(b) If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See § 29.115-1.) If the distributions made during the taxable year exceed the earnings of profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. The provisions of this section may be illustrated by the following example:

Example. At the beginning of the calendar year 1942, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1942 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year, as follows:

Distributions during 1942		Portion out of earnings or profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and prior to taxable year	Taxable amount of each distribution
Date	Amount			
Mar. 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
Sept. 10	15,000	7,500		7,500
Dec. 10	15,000	7,500		7,500
Total amount taxable as dividends				42,000

(c) Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of chapter 1.

§ 29.115-3 *Earnings or profits.* (a) In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

(b) Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see § 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

(c) In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (1) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost of March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery or percentage depletion under all Revenue Acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation. The provisions of this paragraph may be illustrated by the following example:

Example. Oil producing property which A had acquired in 1936 at a cost of $28,000 was transferred to the Y Corporation in December 1938, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was $247,000. The Y Corporation, after four years' operations, effected in 1942 a cash distribution to A in the amount of $165,000. In determining the extent to which the earnings and profits of the Y Corporation available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of $28,000 established in the nontaxable exchange in 1938 regardless of the fair market value of the property or of the stock issued in exchange therefor.

(d) 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 of profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings or profits accumulated since February 28, 1913, and prior to the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. And, if the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings or profits accumulated since the year of the loss to the extent of such earnings.

(e) With respect to the effect on the earnings or profits accumulated since February 28, 1913, of distributions made

on or after January 1, 1916, and prior to August 6, 1917, out of earnings or profits accumulated prior to March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

§ 29.115-4 *Distributions other than a dividend.* Under section 115 (d), any distribution (including a distribution out of earnings or profits accumulated before March 1, 1913) other than:

(a) A dividend (see §§ 29.115-1 and 29.115-2),

(b) A distribution out of increase in value of property accrued prior to March 1, 1913 (see § 29.111-1),

(c) A distribution in partial or complete liquidation (see § 29.115-5), or

(d) A distribution which, under section 115 (f) (1), is not treated as a dividend (see § 29.115-7)

shall be applied against and reduce the adjusted basis of the stock provided in section 113 and shall be taxable to the recipient if, and to the extent that, such distribution exceeds such basis. The provisions of this section are applicable to such distributions received by one corporation from another corporation.

Example. In 1942 the M Corporation purchased certain shares of stock in the O Corporation for $10,000. During that year the M Corporation received a distribution from the O Corporation of $2,000 paid out of earnings or profits of the O Corporation accumulated prior to March 1, 1913. This distribution must be applied by the M Corporation against the basis of its stock in the O Corporation reducing such basis to $8,000. The $2,000 does not constitute a part of the earnings or profits of the M Corporation. If the M Corporation subsequently sells the stock of the O Corporation for $9,000, it realizes a gain of $1,000, which constitutes a part of its earnings or profits for the year in which the stock is sold. If the distribution had amounted to $14,000, the gain of $4,000 would be taxable to the M Corporation and would have constituted a part of the earnings or profits of that corporation for the year in which the distribution was made.

§ 29.115-5 *Distributions in liquidation.* (a) Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and § 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112, and shall be subject to the conditions and limitations provided in section 117.

(b) The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not prorata among the shareholders.

(c) In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining taxability of subsequent distributions by the corporation. (See §§ 29.27 (g)-1 and 29.115-11.)

(d) For the purposes of the last sentence of section 115 (c), a liquidation may be completed prior to the actual dissolution of the liquidating corporation but no liquidation is completed until the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible).

(e) For the purposes of this section the determination of whether a foreign corporation was a foreign personal holding company with respect to a taxable year beginning on or before, and ending after August 26, 1937, shall be made under section 331 of the Revenue Act of 1936 and the regulations thereunder.

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

Example (*1*). A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1931 at a cost of $1,500, and the remainder of 10 shares in December 1941, at a cost of $2,900. He receives in April 1942 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1931, and $2,500 on the 10 shares acquired in December 1941. The gain of $1,000 on the shares acquired in 1931 should be included in A's gross income to the extent of 50 percent, or $500; the loss of $400 on the shares acquired in 1941 should be deducted in computing A's net income to the extent of 100 percent, or $400. (See section 117.)

Example (*2*). A, an individual who makes his income tax returns on the calendar year basis, owned 20 shares of participating preferred stock of the Z Corporation, 10 shares of which were acquired in 1933 for $1,700 and 10 shares of which were acquired in January 1942 for $1,120. In May 1942 the corporation in a transaction qualifying as a partial liquidation redeemed the entire issue of preferred stock by paying the holders thereof $152 per share. A received $1,520 on the 10 shares acquired in 1933, and $1,520 on the 10 shares acquired in January 1942. The loss of $180 on the shares acquired in 1933 should be deducted in computing A's net income to the extent of 100 percent, or $400. the gain of $400 on the shares acquired in January 1942 should be included in A's gross income to the extent of 100 percent, or $400. (See section 117.)

§ 29.115-6 *Distributions from depletion or depreciation reserves.* A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings or profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in § 29.111-1. A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution of prior years, constitutes a part of the corporation's "earnings or profits accumulated after February 28, 1913," within the meaning of section 115, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings or profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. (See § 29.111-1.) No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed.

§ 29.115-7 *Stock dividends.* A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock which would not otherwise be treated as a dividend shall not be so treated merely because such distribution was made out of treasury stock or consisted of rights to acquire treasury stock.

§ 29.115-8 *Election of shareholders as to medium of payment.* (a) If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (a) in money or any other property or (b) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the sixteenth amendment to the Constitution, then the entire distribution is a taxable dividend regardless of:

(1) Whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

(2) Whether the election is exercised or exercisable before or after the declaration of the distribution; or

(3) Whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other.

(b) The term "any other property" as used in this section includes stock of the corporation or rights to acquire its stock, of a class which if distributed without an election would constitute income within the meaning of the sixteenth amendment to the Constitution. (See § 29.115-7.)

§ 29.115-9 *Distribution in redemption or cancellation of stock taxable as a dividend.* (a) If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(b) The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

§ 29.115-10 *Dividends paid in property.* If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See § 29.42-3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

§ 29.115-11 *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.* (a) If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than the permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

(b) If a transaction described in the preceding paragraph has occurred, there shall be included in the accumulated earnings and profits of the transferee corporation as of the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

(c) The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization:

(i) In any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(ii) In any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1936, or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

(5) A distribution described in subparagraph (1), (2), (3), or (4) of this paragraph does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (a), (b), (c), or (e) of this section) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

(d) For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

(e) The distribution, in a taxable year of the distributee beginning after December 31, 1931, by or on behalf of an insolvent corporation, in connection with a section 112 (b) (10) reorganization, of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization, if under section 112 (l) no gain to the distributee from the receipt of such stock or securities was recognized by law.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5304, 8 F. R. 15554, T. D. 5402, 9 F. R. 11053]

§ 29.115-12 *Effect on earnings and profits of gain or loss realized after February 28, 1913.* (a) In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribed certain rules for (1) the computation of the total earnings and profits of the corporation, of

most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules prescribed in this section for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see § 29.115-3). Under both (1) and (2) the adjusted basis is subject to the limitations of the third sentence of section 115 (l) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under (1) and (2) of section 115 (l) depending upon the basis to which the adjustments are to be made. If the application of (2) of the first sentence of section 115 (l) results in a loss and if the application of (1) of such sentence to the same transaction reaches a different result, then the loss under (2) will be subject to the adjustment thereto required by section 115 (m) (2). (See § 29.115-14.)

(b) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this paragraph the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation on January 1, 1942, owned stock in the Y Corporation which it had acquired from the Y Corporation in December 1941, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $30,000. The fair market value of the stock in the Y Corporation when received by the X Corporation was $930,000. On April 9, 1942, the X Corporation made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1941, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of $900,000 representing the excess of the fair market value of the stock of the Y Corporation over the adjusted basis of the property exchanged therefor was not recognized gain to the X Corporation under the provisions of section 112. Accordingly, the earnings and profits of the X Corporation are not increased by $900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of the Y Corporation of the property acquired by it from the X Corporation is $30,000. If such property is thereafter sold by the Y Corporation, gain or loss will be computed on such basis of $30,000, and earnings and profits will be increased or decreased accordingly.

Example (2). On January 2, 1910, the M Corporation acquired nondepreciable prop-

erty at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of the M Corporation was $2,200. On December 31, 1942, the M Corporation transfers such property to the N Corporation in exchange for $1,900 in cash and all the N Corporation stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of the M Corporation the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), $1,900 of which is recognized under section 112 (c), since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by $1,900. In computing the earnings and profits of the M Corporation for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112 (c), the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913, see § 29.115-14.

Example (3). On July 31, 1942, the R Corporation owned oil producing property acquired after February 28, 1913, at a cost of $200,000, but having an adjusted basis (by reason of taking percentage depletion) of $100,000 for determining gain in computing net income. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 115 (l), $150,000. On such day the R Corporation transferred such property to the S Corporation in exchange for $25,000 in cash and all of the S Corporation stock, which had a fair market value of $100,000. For the purpose of computing net income the R Corporation has realized a gain of $25,000 as a result of this transaction, all of which is recognized under section 112 (c). For the purpose of computing earnings and profits, however, the R Corporation has realized a loss of $25,000, none of which is recognized owing to the provisions of section 112 (e). The earnings and profits of the R Corporation are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the S Corporation stock in the hands of the R Corporation for purposes of computing earnings and profits, however, will be $125,000 (though only $100,000 for the purpose of computing net income), computed as follows:

Basis of property transferred	$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred)	50,000
Adjusted basis on stock	125,000

If, therefore, the R Corporation should subsequently sell the S Corporation stock for $100,000, a loss of $25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of the R Corporation.

(c) The third sentence of section 115 (l) provides for cases in which the adjustments, prescribed in section 113, to the basis indicated in paragraph (1) or (2) of the first sentence, as the case may be, of section 115 (l), differ from the adjustments to such basis proper for the purpose of determining earnings or profits.

(d) The adjustments provided by the third sentence of section 115 (l) reflect the treatment provided by § 29.115-3 relative to cases where the deductions for depletion and depreciation in computing net income differ from the deductions proper for the purpose of computing earnings and profits. The effect of such third sentence may be illustrated by the following examples:

Example (1). The X Corporation purchased on January 2, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1942 for $15,000. Under section 113 (b) (1) (B), in determining the gain or loss from the sale of the property, the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost is to be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits will be increased by $7,000, and not by $8,750. The difference of $1,750 is equal to the amount by which the percentage depletion for the year 1932 ($2,750) exceeds the depletion on cost for that year ($1,000) and has already been applied in the computation of earnings and profits for the year 1932 by taking into account only $1,000 instead of $2,750 for depletion in the computation of such earnings and profits (see §§ 29.115-3 and 29.115-6).

Example (*2*). If, in the preceding example, the property, instead of being sold, is exchanged in a transaction described in section 112 (c) for like property having a fair market value of $7,750 and cash of $7,250, then the increase in earnings and profits amounts to $7,000, that is, $15,000 ($7,750 plus $7,250) minus the base of $8,000. However, in computing net income of the X Corporation, the gain is $8,750, that is, $15,000 minus $6,250 ($10,000 less depletion of $3,750), of which only $7,250 is recognized because the recognized gain cannot exceed the sum of money received in the transaction. Section 112 (c) (1), and corresponding provisions of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the increase in earnings and profits would be $2,250, that amount being the gain recognized under section 112.

(e) For adjustment and allocation of the earnings and profits of the transferor as between the transferor and the transferee in cases where the transfer of property by one corporation to another corporation results in the nonrecognition in whole or in part of gain or loss, see § 29.115-11.

§ 29.115-13 *Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.* In order to determine the effect on earnings and profits, where a corporation receives (after February 28, 1913) from a second corporation a distribution which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, section 115 (l) prescribes certain rules. It provides that the amount of such distribution shall not increase the earnings and profits of the first or receiving corporation in the following cases: (1) No such increase shall be made in respect of the part of such distribution which (under the law applicable to the year in which the distribution was made) is directly applied in reduction of the basis of the stock in respect of which the distribution was made and (2) no such increase shall be made if (under the law applicable to the year in which the distribution was made) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received. Where, therefore, the law (applicable to the year in which the distribution was made, as, for example, a distribution in 1934 from earnings and profits accumulated prior to March 1, 1913) requires that the amount of such distribution shall be applied against and reduce the basis of the stock with respect to which the distribution was made, there is no increase in the earnings and profits by reason of the receipt of such distribution. Similarly, where there is received by a corporation a distribution from another corporation in the form of a stock dividend and the law applicable to the year in which such distribution was made requires the allocation, as between the old stock and the stock received as a dividend, of the basis of the old stock, then there is no increase in the earnings and profits by reason of the receipt of such stock dividend even though such stock dividend constitutes income within the meaning of the sixteenth amendment to the Constitution. These principles may be illustrated by the following examples:

Example (*1*). The X Corporation in 1942 distributed to the Y Corporation, one of its shareholders, $10,000 which was out of earnings or profits accumulated before March 1, 1913, and did not exceed the adjusted basis of the stock in respect of which the distribution was made. This amount of $10,000 was, therefore, a tax-free distribution and under the provisions of section 115 (b) must be applied against and reduce the adjusted basis of the stock in respect of which the distribution was made. The earnings and profits of the Y Corporation are not increased by reason of the receipt of this distribution.

Example (*2*). The Z Corporation in 1934 had outstanding, common and preferred stock of which the Y Corporation held 100 shares of the common and no preferred. The stock had a cost basis to the Y Corporation of $100 per share, or a total cost of $10,000. In December of that year it received a dividend of 100 shares of the preferred stock of the Z Corporation. Such distribution is a stock dividend which, under section 115 (f) of the Revenue Act of 1934, was not taxable and was accordingly not included in the gross income of the Y Corporation. The original cost of $10,000 is allocated to the 200 shares of the Z Corporation none of which has been sold or otherwise disposed of by the Y Corporation. See section 113 (a) (19) and §§ 29.113 (a) (19)-1 and 29.113 (a) (12)-1. The earnings and profits of the Y Corporation are not increased by reason of the receipt of such stock dividend.

§ 29.115-14 *Adjustments to earnings and profits reflecting increase in value accrued prior to March 1, 1913.* (a) In order to determine, for the purpose of ascertaining the source of dividend distributions, that part of the earnings and profits which is represented by increase in value of property accrued before, but

realized on or after, March 1, 1913, section 115 (m) prescribes certain rules.

(b) Paragraph (1) of section 115 (m) sets forth the general rule with respect to computing the increase to be made in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913. The effect of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation acquired nondepreciable property prior to March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000 and it was sold in 1942 for $15,000. The increase in earnings and profits based on the value as of March 1, 1913, representing earnings and profits accumulated since February 28, 1913, is $3,000. If the basis is determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $5,000. The difference of $2,000 ($5,000 minus $3,000) represents the increase to be made in that part of the earnings and profits of the X Corporation consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). The Y Corporation acquired depreciable property in 1908 at a cost of $100,000. Assuming no additions or betterments, and that the depreciation sustained prior to March 1, 1913, was $10,000, the adjusted cost as of that date was $90,000. Its fair market value as of March 1, 1913, was $94,000 and in 1942 it was sold for $60,000. For the purpose of determining gain from the sale, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If the amount of the depreciation deduction allowed (not less than the amount allowable) after February 28, 1913, to the date of the sale in 1942 is the aggregate sum of $43,240, the adjusted basis for determining gain in 1942 ($94,000 less $43,240) is $50,760 and the gain would be $9,240 ($60,000 less $50,760). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the value as of March 1, 1913, adjusted for depreciation, is $9,240. If the depreciation since February 28, 1913, had been based on the adjusted cost of $90,000 ($100,000 less $10,000) instead of the March 1, 1913, value of $94,000, the depreciation sustained from that date to the date of sale would have been $41,400 instead of $43,240 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $48,600 ($100,000 reduced by the sum of $10,000 and $41,400) would be $11,400 ($60,000 less $48,600). If the adjusted basis of the property was determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $11,400. The difference of $2,160 ($11,400 minus $9,240) represents the increase to be made in that part of the earnings and profits of the Y Corporation consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

(c) Paragraph (2) of section 115 (m) is an exception to the general rule in paragraph (1) of such section and also operates as a limitation on the application of section 115 (l). It provides that, if the application of (2) of the first sentence of section 115 (l) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding section 115 (l) and in lieu of the rule provided in paragraph (1) of section 115 (m), the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the fair market value of the property on March 1, 1913. If the amount so applied in reduction of the loss exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913. The following examples will show the application of section 115 (m) (2):

Example (1). The Y Corporation acquired nondepreciable property prior to March 1, 1913, at a cost of $8,000, its fair market value as of March 1, 1913, was $13,000, and it was sold in 1942 for $10,000. Under (2) of the first sentence of section 115 (l) the adjusted basis would be $13,000 and there would be a loss of $3,000. The application of (2) of the first sentence of section 115 (l) would result in a loss from the sale in 1942 to be applied in decrease of earnings and profits for that year. Section 115 (m) (2), however, applies and the loss of $3,000 is reduced by the amount by which the adjusted basis of $13,000 exceeds the cost of $8,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $5,000. The amount of the loss is, accordingly, reduced from $3,000 to zero and there is no decrease in earnings and profits of the Y Corporation for the year 1942 as the result of the sale. The amount applied in reduction of the decrease, namely, $5,000, exceeds $3,000. Accordingly, as a result of the sale the excess of $2,000 increases that part of the earnings and profits of the Y corporation consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). The Z Corporation acquired nondepreciable property prior to March 1, 1913, at a cost of $10,000, its fair market

value as of March 1, 1913, was $12,000, and it was sold in 1942 for $8,000. Under (2) of the first sentence of section 115 (l) the adjusted basis would be $12,000 and there would be a loss of $4,000. The application of (2) of the first sentence of section 115 (l) would result in a loss from the sale in 1942 to be applied in decrease of earnings and profits for that year. Section 115 (m) (2), however, applies and the loss of $4,000 is reduced by the amount by which the adjusted basis of $12,000 exceeds the cost of $10,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $2,000. The amount of the loss is, accordingly, reduced from $4,000 to $2,000 and the decrease in earnings and profits of the Z Corporation for the year 1942 as the result of the sale is $2,000 instead of $4,000. The amount applied in reduction of the decrease, namely $2,000, does not exceed $4,000. Accordingly, as the result of the sale there is no increase in that part of the earnings and profits of the Z Corporation consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

§ 29.116-1 *Earned income from sources without the United States.* (a) For taxable years beginning after December 31, 1942, there is excluded from gross income earned income in the case of an individual citizen of the United States provided the following conditions are met by the taxpayer claiming such exclusion from his gross income: (1) It is established to the satisfaction of the Commissioner that the taxpayer has been a bona fide resident of a foreign country or countries throughout the entire taxable year; (2) such income is from sources without the United States; (3) Such income would constitute earned income as defined in section 25 (a) if received from sources within the United States for taxable years beginning before January 1, 1944, or as defined in section 116 (a) (3) for taxable years beginning after December 31, 1943; and (4) such income does not represent amounts paid by the United States or any agency or instrumentality thereof. Hence, a citizen of the United States taking up residence without the United States in the course of the taxable year is not entitled to such exemption for such taxable year. However, once bona fide residence in a foreign country or countries has been established, temporary absence therefrom in the United States on vacation or business trips will not necessarily deprive such individual of his status as a bona fide resident of a foreign country. Whether the individual citizen of the United States is a bona fide resident of a foreign country shall be determined in general by the application of the principles of §§ 29.211-2, 29.211-3, 29.211-4, and 29.211-5 relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual.

(b) For any taxable year beginning after December 31, 1941, in the case of an individual citizen of the United States, there shall be excluded from gross income earned income from sources without the United States derived during the period of his foreign residence if (1) such citizen was a bona fide resident of a foreign country or countries for at least two years prior to the date upon which he became a resident of the United States and ceased to be a resident of such foreign country or countries; (2) Such income would constitute earned income as defined in section 25 (a) if received from sources within the United States for taxable years beginning before January 1, 1944, or as defined in section 116 (a) (3) for taxable years beginning after December 31, 1943; and (3) such income does not represent amounts paid by the United States or any agency or instrumentality thereof. The application of this provision may be illustrated by the following example:

Example. A, a United States citizen making his return on a calendar year basis, has been a resident of X country for a period of four years ended June 30, 1942, upon which date he becomes a resident of the United States and ceases to be a resident of X country. Throughout the years 1940 and 1941, A had rendered personal services in the X country payment for which was not made until August 1942, at which time he was paid for such services the sum of $50,000. Such amount may be excluded from gross income of A for the calendar year 1942.

(c) In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 116 (a), there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions properly applicable to or chargeable against the amounts so excluded from gross income.

(d) The entire amount received as professional fees may be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or all of the

services, provided the clients or patients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

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

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5373, 9 F. R. 5502]

§ 29.116-2 *Income of foreign governments, international organizations, and their employees.*—(a) *Foreign governments and their employees.* The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax.

All employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (1) the services are of a character similar to those performed by employees of the Government of the United States in such foreign country and (2) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country. Section 116 (h) (2) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries. The income received by employees of foreign governments from sources other than their salaries, fees, or wages, referred to above, is subject to Federal income tax. The compensation of citizens of the United States who are officers or employees of a foreign government is not exempt from income tax. (But see section 116 (a).) Subject to the same conditions, wages, fees, or salaries of an employee of the Commonwealth of the Philippines received as compensation for official services rendered to such commonwealth are exempt from Federal income tax subject to the same kind of certification by the Secretary of State to the Secretary of the Treasury. Such latter exemption does not apply to a citizen of the United States unless he is also a citizen of the Commonwealth of the Philippines. (See section 251.) Under the provisions of the tax convention between the United States and France, and without regard to any other provision of this section, compensation paid by France to French citizens for labor or personal services performed in the United States is exempt from Federal income tax. (See §§ 7.400 to 7.409, inclusive.) Similarly, under the provisions of the tax convention between the United States and Sweden, wages, salaries, and similar compensation and pensions paid by Sweden or by any political subdivision or territory or posseession thereof to individuals (other than citizens of the United States) residing in the United States are also exempt from Federal income tax. (See §§ 7.200 to 7.218, inclusive.) Similarly, under the tax convention between the United States and Canada (effective January 1, 1941), wages, salaries, and similar compensation paid by Canada or by any agency or instrumentality thereof or by any of the political subdivisions or territories or possessions of Canada to citizens of Canada residing in the United States are also exempt from Federal income tax. (See §§ 7.10 to 7.17, inclusive.)

(b) *International organizations and their employees.* (1) Subject to the provisions of section 1 of the International Organizations Immunities Act (the provisions of which section are hereinafter set forth), the income of an international organization (as defined in section 3797 (a) (18)) received from investments in the United States in stocks, bonds, or

other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax. An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (1) the Executive order does not provide otherwise and (2) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received. The exemption is effective only with respect to taxable years beginning after December 31, 1943.

(2) Subject to the provisions of sections 1, 8, and 9 of the International Organizations Immunities Act, wages, fees, or salary of any officer or employee of an international organization (as defined in section 3797 (a) (18)) received as compensation for official services to such international organizations is exempt from Federal income tax, if such officer or employee (1) is not a citizen of the United States or (2) is a citizen of the Commonwealth of the Philippines (whether or not a citizen of the United States). An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to and accepted by the Secretary of State as an officer or employee of such organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of such organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by such individual either prior to the date of the issuance of such Executive order, or prior to the date of such acceptance or designation by the Secretary of State, for official services to such organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participated pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such compensation is earned, and (3) the individual is an officer or employee of such organization at such time. The compensation of citizens of the United States (other than citizens of the Commonwealth of the Philippines who are officers or employees of an international organization is not exempt from income tax. (But see section 116 (a).) The exemption with respect to wages, fees, or salary, referred to above, is effective only with respect to taxable years beginning after December 31, 1943.

(3) Sections 1, 8, and 9 of the International Organizations Immunities Act provide as follows:

SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term "international organization" means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

* * * * *

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall

have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *.

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * * , and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * *, provided for in this title (International Organizations Immunities Act), shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided,* That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5326, 9 F. R. 367, D. T. 5522, 11 F. R. 6754]

§ 29.116-3 *Bridges to be acquired by State or political subdivisions.* (a) Any State or political subdivision thereof claiming a refund under the provisions of section 116 (e) of an amount equal to all or a portion of any income tax levied, assessed, collected, and paid in the manner and at the rates prescribed in chapter 1, shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the collector of internal revenue for the district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain:

(1) A statement of the name of the taxpayer, of the amount of tax levied, assessed, collected, and paid for the taxable year or period in respect of which the claim is made, and the amount of refund thereby sought;

(2) A full statement of the facts considered by the claimant sufficient to entitle it to receive the refund, including copies of all contracts and other documents bearing on the case, and a statement that the claim is submitted under the provisions of section 116 (e);

(3) A showing which will establish to the satisfaction of the Commissioner that the fiscal officer presenting the claim has authority to receive the amount of the refund on behalf of the State or political subdivision which he assumes to represent and to apply without delay the entire amount of such refund in part payment for the acquisition of such bridge, including copies of the laws, ordinances, or similar enactments considered by the claimant sufficient to establish its authority to receive the refund and so to apply it, together with a statement that such fiscal officer will receive and immediately so apply the entire amount of the refund; and

(4) An affidavit made by or on behalf of the taxpayer, which affidavit shall state that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amount refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at 6 percent per annum from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(b) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of

a State or States are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 116 (e) and this section is not considered an overpayment within the meaning of section 3771 relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(c) A check or voucher in payment of a claim for refund allowed under section 116 (e) will be drawn in the name of the fiscal officer or officers having authority, as established under paragraph (a) (3) of this section, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in section 116 (e) and this section.

§ 29.116–4 *Exclusion of certain cost-of-living allowances.* (a) For taxable years beginning after December 31, 1942, certain cost-of-living allowances and post allowances of Government civilian personnel stationed outside continental United States are, by the provisions of section 116 (j), excluded from gross income. Cost-of-living allowances and post allowances, excluded from gross income pursuant to the provisions of section 116 (j), shall be considered as retaining their characteristics under the subsection notwithstanding any possible combination thereof with any other allowance, such as a quarters allowance, as, for example, in a "living and quarters allowance", whether or not such other allowance is excluded from gross income.

(b) For the purposes of section 116 (j) the term "continental United States" includes only the States of the Union and the District of Columbia.

[T. D. 5367, 9 F. R. 4976]

§ 29.116–5 *Exclusion of certain allowances of Foreign Service personnel.* Amounts received on or after November 13, 1946, by personnel of the Foreign Service of the United States as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (60 Stat. 999) are, by the provisions of section 116 (k), excluded from gross income.

[T. D. 5555, 12 F. R. 2050, 2288]

§ 29.117–1 *Meaning of terms.* (a) The term "capital assets" includes all classes of property not specifically excluded by section 117 (a) (1). In determining whether property is a "capital asset," the period for which held is immaterial.

(b) The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23 (l) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117 (b) and losses from such transactions are not subject to the limitations on losses provided in section 117 (d), except that under section 117 (j) the gains and losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See § 29.117–7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23 (l) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117 (b), (c), and (d). The term "ordinary net income" as used in these regulations for the purpose of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

(c) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act provides that United States Treasury bills shall be issued on a discount basis, the

issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the fact amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term "capital assets," gains or losses from the sale or exchange of such obligations are not subject to the percentage provisions of section 117 (b) and losses from such transactions are not subject to the limitation on losses provided in section 117 (d). It is, therefore, not necessary for a taxpayer, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 29.42-7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

(d) Section 117 (a) (2) to (9), inclusive, defines "short-term capital gain," "short-term capital loss," "long-term capital gain," "long-term capital loss," "net short-term capital gain," "net short-term capital loss," "net long-term capital gain," and "net long-term capital loss." These terms are used in the subsequent subsections of section 117.

(c) The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for six months or less; the phrase "long-term" to the category of gains and losses arising from the sale or exchange of capital assets held for more than six months. The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 117 (d) does not mean that such loss is not "taken into account in computing net income" within the meaning of that phrase as used in section 117 (a) (3) and (5).

(f) In the definition of "net short-term capital gain," as provided in section 117 (a) (6), the amounts brought forward to the taxable year under section 117 (e) are short-term capital losses for such taxable year.

(g) Gains and losses from the sale or exchange of capital assets held for not more than six months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than six months (described as long-term capital gains and long-term capital losses). The percentage brackets of section 117 (b) have no application to corporations, corporate gains and losses being taken into account to the full extent, without regard to the length of time the capital assets are held (though because of the limitation in section 117 (d) such losses may not be deductible in full).

(h) Section 117 (a) (10) defines "net capital gain." In the case of a corporation the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges, which losses include any amounts brought forward pursuant to section 117 (e). In the case of a taxpayer other than a corporation the term "net capital gain" means the excess of (1) the sum of the gains from sales or exchanges of capital assets, plus net income (computed without regard to gains and losses from sales or exchanges of capital assets) of the taxpayer or $1,000, whichever is smaller, over (2) the losses from such sales or exchanges, which losses include amounts brought forward under section 117 (e).

(i) For taxable years beginning after December 31, 1948, in the case of a taxpayer whose tax liability is computed under Supplement T, the term "net income," as used in the preceding sentence, shall be read as "adjusted gross income." In the determination of adjusted gross income (prior to the determination of "net capital gain") there shall be taken into account the same percentages of the gain or loss as are taken into account in computing net income. For application of the term "net capital gain," in

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computing the capital loss carry-over under section 117 (e), see § 29.117-2 (c).

(j) Section 117 (a) (11) defines "net capital loss" to mean the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 117 (d). However, amounts which are short-term capital losses under section 117 (e) (1) are excluded in determining such "net capital loss."

(k) See section 23 (g) and (k), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under section 117 from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged. See also section 117 (j) and § 29.117-7 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 17]

§ 29.117-2 *Percentage of capital gain or loss taken into account; net loss carry-over*—(a) *General.* In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. For instance, if unimproved real estate purchased by an individual for $20,000 is a capital asset and is sold by him for $25,000 after having been held for more than six months, only 50 percent of the recognized gain ($5,000), or $2,500, shall be taken into account in computing net income; or if such property is sold for $14,000, only 50 percent of the recognized loss ($6,000), or $3,000, shall be so taken into account.

(b) *Limitation on capital losses.* Section 117 (d) (1) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of the gains from such sales or exchanges, and section 117 (d) (2) provides that, in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of the gains from such sales or exchanges, plus net income (computed without regard to such gains or losses) of the taxpayer or $1,000, whichever is smaller. Thus, where an individual taxpayer, having an ordinary net income of $5,000 has a net long-term capital loss of $4,000, of which $2,000 (50% of $4,000) is taken into account, the net loss of $2,000 is allowable only to the extent of $1,000, the remaining $1,000 being an unallowable deduction. If the taxpayer's ordinary net income, computed without capital gains and losses, had been $400 instead of $5,000, only $400 of the net loss of $2,000 would have been allowed, giving the taxpayer no taxable income and an unallowable capital loss of $1,600. (For disposition of the unallowable capital loss, see paragraph (c) of this section.) However, in the case of banks, as defined in section 104, the limitation under section 117 (d) (1) is modified by section 117 (i) so that the excess of any losses of the taxable year from sales or exchanges of bonds, debentures, notes or certificates, or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof) with interest coupons or in registered form, over gains of the taxable
istered form, over gains of the taxable
be deductible in full as an ordinary loss.
be deductible in full as an ordinary loss.
In case the tax is computed under Supfor taxable years beginning after December 31, 1943, be read as "adjusted gross income."

(c) *Net capital loss carry-over.* Any taxpayer sustaining a net capital loss may, under section 117 (e) (1), carry over such loss to each of the five succeeding taxable years and treat it in each such five succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carry-over is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the net capital loss carry-over may not be included in computing a new net capital loss of a taxable

year which can be carried forward to the next five succeeding taxable years.

The practical operation of the provisions of section 117 (e) (1) may be illustrated by the following example:

Example. For the taxable years 1942 to 1946, inclusive, a taxpayer is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and net income as follows:

	1942	1943	1944	1945	1946
Carry-over from prior years:					
From 1942		($50,000)	($29,500)	($29,500)	
From 1944				(19,500)	($13,000)
Net short-term loss (computed without regard to the carry-overs)	($30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carry-overs)				40,000	
Net long-term loss	(20,500)		(10,000)	(5,000)	
Net long-term gain		25,000			
Net capital gain (computed without regard to the carry-overs)		20,500		36,000	
Net income (computed without regard to capital gains or losses)	500	500	500	1,000	
Net capital loss	(50,000)	None	(19,500)	None	

Net Capital Loss of 1942

The net capital loss is $50,000. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges, and (2) net income of $500. This amount may be carried forward in full to 1943. However, in 1943 there was a net capital gain of $20,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1944 and 1945 since there was no net capital gain in 1944. In 1945 this $29,500 shall be allowed in full against net capital gain of $36,000, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1).

Net Capital Loss of 1944

The net capital loss is $19,500. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges and (2) net income of $500. This amount may be carried forward in full to 1945. However, in 1945 there was a net capital gain of $6,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $19,500 is allowed in part. The remaining portion—$13,000—may be carried forward to 1946.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 17]

§ 29.117-3 *Alternative tax in case of net long-term capital gain or loss.* (a) In case the net long-term capital gain of a taxpayer (other than a corporation) exceeds the net short-term capital loss, section 117 (c) (2) imposes an alternative tax in lieu of the tax imposed by sections 11 and 12, if and only if such alternative tax is less than the tax imposed by sections 11 and 12. For any such taxable year this alternative tax is the sum of (1) a partial tax, computed at the rates provided by sections 11 and 12, on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) 50 percent of such excess.

(b) In case the net long-term capital gain of any corporation exceeds the net short-term capital loss, section 117 (c) (1) imposes an alternative tax in lieu of the tax imposed by sections 13, 14, 15, 204, 207 (a) (1) or (3), and 500, if and only if such alternative tax is less than the tax imposed by such sections. For any such taxable year this alternative tax is the sum of (1) a partial tax computed at the rates provided by sections 13, 14, 15, 204, 207 (a) (1) or (3), and 500 on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) 25 percent of such excess.

(c) The following example will illustrate the practical operation of the provisions of this section in the case of a taxpayer other than a corporation:

Example. Suppose that A, an individual, has for the calendar year 1942 an ordinary net income of $100,000, none of which consists of interest on the obligations of the United States or its instrumentalities. He is entitled to a personal exemption of $1,200 and to no credit for dependents, and his earned net income is $3,000. He realizes in that year a gain of $100,000 on a capital asset held for 19 months and sustained a loss of $20,000 on a capital asset held for 5 months. Since the alternative tax is less than the tax otherwise computed under sections 11 and 12, the correct tax is the alternative tax, that is, $79,126. The tax is computed as follows:

Tax Under Sections 11 and 12

Ordinary net income		$100,000.00
Net long-term capital gain: (50 percent of $100,000)	$50,000.00	
Net short-term capital loss: (100 percent of $20,000)	20,000.00	
Excess of the net long-term capital gain over the net short-term capital loss		30,000.00
Total net income		130,000.00
Less:		
Credit for personal exemption		1,200.00
Surtax net income		128,800.00
Less earned income credit (10 percent of $3,000)		300.00
Income subject to normal tax		128,500.00
Normal tax (6 percent of $128,500)		7,710.00
Surtax on $128,800		81,892.00
Total tax		89,602.00

Alternative Tax Under Section 117 (c) (2)

Net income	$130,000.00
Less:	
Excess of the net long-term capital gain over the net short-term capital loss	30,000.00
Ordinary net income	100,000.00
Less credit for personal exemption	1,200.00
Surtax net income	98,800.00
Less earned income credit (10 percent of $3,000)	300.00
Income subject to normal tax	98,500.00
Normal tax (6 percent of $98,500)	5,910.00
Surtax on $98,800	53,216.00
Partial tax under sections 11 and 12 on $100,000	64,126.00
Plus 50 percent of $30,000	15,000.00
Total alternative tax	79,126.00

§ 29.117-4 *Determination of period for which capital assets are held.* (a) Under section 117 (h) if property is acquired in certain transactions described in sections 112, 113, 118, and 371 (c), the period for which such property is considered to have been held by the taxpayer is not computed from the date such property was acquired by the taxpayer but from a prior date. For instance: In the case of stock or securities in a corporation a party to a reorganization received pursuant to a plan of reorganization in exchange solely for stock or securities in another corporation a party to the reorganization, the period for which the stock or securities exchanged were held by the taxpayer must be included in the period for which the stock or securities received on the exchange were held by the taxpayer. In the case of property acquired after December 31, 1920, by gift (if under the provisions of section 113, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor), the period for which the property was held by the donor must be included in the period for which the property was held by the taxpayer. In the case of stock or securities the acquisition of which resulted in the nondeductibility (under section 118 of the Internal Revenue Code or under section 118 of the Revenue Act of 1928, 1932, 1934, 1936, or 1938) of the loss from the sale or other disposition of substantially identical stock or securities, the period for which the stock or securities the loss from the sale or other disposition of which was not deductible were held must be included in the period for which the stock or securities acquired were held by the taxpayer. If property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 113 (a) (9) the same basis in whole or in part in the hands of the taxpayer as the property so converted, the period for which the property so converted was held by the taxpayer must be included in the period for which the property acquired was held by the taxpayer.

(b) The period for which the taxpayer has held stock, or stock subscription rights, issued to him as a dividend shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is fixed by the apportionment of the basis of such old stock.

(c) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of

the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

§ 29.117-5 *Application of section 117 in the case of husband and wife*—(a) *Taxable year beginning in 1942.* If a husband and wife making a joint return for the first taxable year beginning in 1942, did not make a joint return for the preceding taxable year, the individual net short-term capital loss of each spouse for the preceding taxable year (in an amount not in excess of the individual net income of such spouse for such year) shall be totaled and such total shall be a short-term capital loss for such first taxable year beginning in 1942, to the extent of the excess of short-term capital gains over short-term capital losses for such year. If, however, a joint return was made for such preceding taxable year, a net short-term capital loss as shown by such joint return (in an amount not in excess of the aggregate net income for such year as shown by such return) shall be a short-term capital loss for the first taxable year beginning in 1942, to the extent of the excess of short-term capital gains over the short-term capital losses for such year. If a husband and wife making separate returns for the first taxable year beginning in 1942, made a joint return for the preceding taxable year, a net short-term capital loss shown by such joint return shall be allocated to the spouses on the basis of their individual net short-term capital losses for such preceding taxable year, and the net short-term capital loss allocated to each spouse (in an amount not in excess of the portion of the aggregate net income shown by such joint return attributable to such spouse) shall be treated as a short-term capital loss of such spouse for the first taxable year beginning in 1942 to the extent of the excess of short-term capital gains over short-term capital losses of such spouse for such year.

(b) *Taxable years beginning after December 31, 1942.* (1) In the case of a husband and wife making a joint return, the limitation under section 117 (d) (2), relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined capital gains and losses of the spouses.

(2) If a husband and wife making a joint return for any taxable year beginning after December 31, 1942, did not make a joint return for the preceding taxable years (not exceeding five taxable years and beginning after December 31, 1941), the individual net capital loss of each spouse for each of such preceding taxable years shall be a short-term capital loss for the taxable year to the extent provided by section 117 (e) (1). If, however, a joint return was made for each of the preceding taxable years (not exceeding five taxable years and beginning after December 31, 1941), a net capital loss as shown by each joint return shall be a short-term capital loss for the taxable year to the extent provided by section 117 (e) (1). If a husband and wife making separate returns for any taxable year beginning after December 31, 1942, made a joint return for each of the preceding taxable years (not exceeding five taxable years and beginning after December 31, 1941), a net capital loss as shown by each such joint return shall be allocated to the spouses on the basis of their individual net capital losses for each of such preceding taxable years, and the net capital loss allocated to each spouse shall be a short-term capital loss of such spouse for the taxable year, to the extent provided by section 117 (e) (1).

(3) The alternative taxes computed under section 117 (c) (2) are in lieu of taxes imposed by sections 11 and 12 and must be compared with the tax imposed by such sections to determine which tax is applicable. In computing the alternative taxes under section 117 (c) (2), in the case of a joint return, the determination of the excess of the net long-term capital gains over the net short-term capital losses is to be made by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

§ 29.117-6 *Gains and losses from short sales.* For income tax purposes, a short sale is not deemed to be consummated until delivery of property to cover the short sale, and the percentage of the recognized gain or loss to be taken into account under section 117 (b) from a short sale shall be computed according

to the period for which the property so delivered was held. Thus, if a taxpayer made a short sale of shares of stock and covered the short sale by purchasing and delivering shares which he held for not more than six months, 100 percent of the recognized gain or loss would be taken into account under section 117 (b), even though he had on hand other shares of the same stock which he held for more than six months. If the short sale is made through a broker and the broker borrows property to make delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

§ 29.117-7 *Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business*. (a) Section 117 (j) provides that the recognized gains and losses:

(1) From the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is:

(i) Of a character subject to the allowance for depreciation provided in section 23 (l), or

(ii) Real property,

Provided, That such property is not of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business, and

(2) From the involuntary conversion of capital assets held for more than six months, and

(3) From timber held for more than six months which is considered to have been sold under the provisions of section 117 (k) (2), and with respect to taxable years beginning after December 31, 1943, from timber owned or held under a contract right to cut for more than six months prior to the beginning of the taxable year which is considered to have been sold or exchanged under the provisions of section 117 (k) (1), regardless of whether such timber would be properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or whether such timber was held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

(b) In determining whether such gains exceed such losses for the purposes of section 117 (j), losses upon the destruction in whole or in part, theft or seizure, requisition or condemnation of the property described in section 117 (j) are included whether or not there was a conversion of such property into money or other property. For example, if a capital asset held for more than six months, with an adjusted basis of $400, is stolen, and the loss from this theft is not compensated for by insurance or otherwise, the $400 loss is included in the computations under section 117 (j) to determine whether gains exceed losses. Furthermore, in making this computation, the gains and losses described in section 117 (j) are taken into account without regard to the percentage provisions of section 117 (b), that is, 100 percent of such gains and losses is taken into account. For example, if a taxpayer sustains a loss of $400 upon the sale under threat of condemnation of a capital asset, held for more than six months, such loss is taken into account for the purposes of section 117 (j) to the extent of $400, even though only $200 would be taken into account under section 117 (b) in computing net income. Similarly, the provisions of section 117 (d) limiting the deduction of capital losses are not applicable to exclude any losses from the computations under section 117 (j). With these exceptions as to sections 117 (b) and 117 (d), gains and losses are included in the computations under section 117 (j) only to the extent that they are taken into account in computing net income. Thus, losses which are not deductible items under section 24 or section 118 are not included in the computations under section 117 (j). Similarly, if a taxpayer reports on the installment basis under section 44 the gain on the sale of property described in section 117

(j), only the portion of the gain reported under section 44 in computing net income for the taxable year is included in the computations for such taxable year under section 117 (j). Any gains and losses which are not recognized under section 112 are not included in the computations under section 117 (j). Thus, if property is involuntarily converted into similar property, so that the gain on such conversion is not recognized under the provisions of section 112 (f), such gain is not included in the computations under section 117 (j).

(c) If it is determined under the above computations that the gains exceed the losses, all of such gains and losses are treated as gains and losses from the sale or exchange of capital assets held for more than six months. All such gains and losses are then subject to the limitations of section 117 (b), (c), and (d), relating to the percentage taken into account, the alternative tax in the case of capital gains and losses, and the extent to which capital losses are allowed. If it is determined under the above computations that the gains do not exceed the losses, none of such gains and losses are treated as gains and losses from the sale or exchange of capital assets. Such gains and losses are then not subject to the percentage limitations of section 117 (b), and such losses are not subject to the limitations provided in section 117 (d). For example, if the taxpayer during the taxable year has losses of $1,000 on the sale of certain depreciable machinery used in his trade or business, held for more than six months, and a gain of $400 on the sale under threat of condemnation of a capital asset held for more than six months, such losses exceed such gain, and such losses and gain are not treated as losses and gain from the sale or exchange of capital assets. The gain on the sale of the capital asset would therefore be taken into account in full, instead of to the extent of 50 percent as provided in section 117 (b).

(d) Section 117 (j) does not apply to gains and losses on the sale, exchange, or involuntary conversion of any property which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, but not including as such property timber which is considered to have been sold or exchanged as provided in section 117 (k) (1) or which has been sold as provided in section 117 (k) (2). The involuntary conversion of property described in section 117 (j) is the conversion of such property into money or other property as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof.

(e) The following examples will illustrate the operation of the provisions of section 117 (j):

Example (1). A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1942 of the kind described in section 117 (j), computed without regard to the limitations in section 117 (b), are as follows:

	Gains	*Losses*
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than six months	$4,000	
2. Gain reported in 1942 (under section 44) on installment sale in 1941 of factory premises used in the business (including building and land, each held for more than six months)	6,000	
3. Gain reported in 1942 (under section 44) on installment sale in 1942 of land held for more than six months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than six months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than six months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.)		$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than six months		5,000
7. Loss in storm of pleasure yacht, purchased in 1940 for $1,800 and having a fair market value of $1,000 at the time of the storm		1,000
8. Total gains	12,500	
9. Total losses		9,000
10. Excess of gains over losses	3,500	

Since the aggregate of the respective recognized gains ($12,500) exceeds the aggregate of such losses ($9,000), such gains and losses are treated under section 117 (j) as gains and losses from the sale or exchange of capital assets held for more than six months. Therefore, under the provisions of section 117 (b), A will take into account only 50 percent of the amounts of items 1 to 7. Such items are treated the same as any other long-term gains and losses of A, and will cause the inclusion of $1,750 (50 percent of item 10) in computing his net long-term capital gain for the purposes of the alternative tax provided by section 117 (c) (2).

Example (2). A's yacht, used for pleasure and acquired for such use in 1935 at a cost of $25,000, was requisitioned by the Government in 1942 for $15,000. A sustained no deductible loss, and no loss with respect to such requisition will be included in the computations under section 117 (j).

Example (3). If in example (1) the taxpayer were a corporation, then there would be taken into account 100 percent of the gains and losses in items 1 to 7, which are treated for all purposes as gains and losses from the sale or exchange of capital assets held for more than six months. The percentage provisions of section 117 (b) do not apply to corporations. These items will cause the inclusion of $3,500 (item 10) in computing the net long-term capital gain of the corporation for the purposes of the alternative tax provided by section 117 (c) (1).

Example (4). If in example (1) A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset held for more than six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000, or $13,000). Neither the loss on such sale of a capital asset nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchange of capital assets, but all of such items would be treated as ordinary gains and losses. Since all of such items are included in full in computing net income, the net effect of such items will be the inclusion in computing net income of a loss of $500 (the excess of the $13,000 losses over the $12,500 gains). This same result would be obtained if A were a corporation. If the loss on the sale of the capital asset under threat of condemnation were $3,500, the gains and losses would still be treated as ordinary gains and losses and not as capital gains and losses, since the gains ($12,500) would not exceed the losses ($9,000 plus $3,500, or $12,500).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 9136]

§ 29.117-8 *Gain or loss upon the cutting and disposal of timber*—(a) *Gain or loss upon the cutting of timber*—(1) *Election to consider cutting as a sale or exchange.* (i) With respect to a taxable year beginning after December 31, 1943, a taxpayer who has owned, or has held a contract right to cut, timber for a period of more than six months prior to the beginning of such taxable year may elect under section 117 (k) (1) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. Such election must be made by the taxpayer in its income tax return for the taxable year, and cannot be made thereafter. The election shall take the form of a computation in the return under the provisions of section 117 (k) (1) and section 117 (j).

(ii) The election provided by section 117 (k) (1) need not be made with respect to the first taxable year of the taxpayer beginning after December 31, 1943, to which the provisions of such section are applicable. Such election may be made for any taxable year beginning after December 31, 1943, to which the provisions of section 117 (k) (1) are applicable.

(iii) The election made under the provisions of section 117 (k) (1) shall be applicable with respect to all timber which was owned by the taxpayer or which the taxpayer had a contract right to cut, and the cutting of timber, whether or not actually sold or exchanged, shall be considered to be a sale or exchange, except that timber which is not cut for sale or for use in the taxpayer's trade or business and timber which was held for a period of not more than six months prior to the beginning of the taxable year shall not be considered to have been sold or exchanged upon the cutting thereof. If an election has been made under the provisions of section 117 (k) (1), such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than six months prior to the beginning of a subsequent taxable year and which was cut for sale or for use in the taxpayer's trade or business, whether such timber or contract right was acquired prior or subsequent to the election. If the taxpayer has revoked his election, such revocation shall preclude any further elections by the taxpayer

under section 117 (k) (1), except with the consent of the Commissioner.

(2) *Computation of gain or loss.* (i) If the cutting of timber is considered as a sale or exchange pursuant to an election made under the provisions of section 117 (k) 1, gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of such cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in § 29.23 (m)-21 with respect to the computation of the allowance for depletion.

(ii) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the Commissioner upon examination of the taxpayer's return, by the taxpayer electing to apply the provisions of section 117 (k) (1) in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in § 29.23 (m)-25.

(iii) The fair market value as of the beginning of the taxable year of the timber cut during such year shall be considered to be the cost of the timber which was cut, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. Thus if the products of the timber cut during a taxable year were sold during such year. the fair market value as of the beginning of such taxable year of the timber cut during the year shall be used in computing the depletion unit and the allowance for depletion as provided in § 29.23 (m)-21. This is also the rule in case the products of the timber cut during one taxable year with respect to which an election has been made under section 117 (k) (1) are sold during a subsequent taxable year, whether or not the election provided in section 117 (k) (1) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 117 (k) (1) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See § 29.22 (c)-3. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the elective method provided by section 22 (d) if such section is applicable to, and has been elected by, the taxpayer.

(iv) For any taxable year beginning after December 31, 1943, for which the cutting of timber is considered to be a sale or exchange of such timber under section 117 (k) (1), the timber so cut shall be considered as property used in the trade or business for the purposes of section 117 (j) along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1). Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than six months depends upon the application of section 117 (j) to the taxpayer for the taxable year. See § 29.117-7.

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(v) In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of a manufactured product, the income from such actual sale shall be considered ordinary income. In determining the cost of the products so sold, the cost of the timber shall be computed pursuant to the provisions of section 117 (k) (1).

(b) *Gain or loss upon the disposal of timber under cutting contract.* If a taxpayer disposes of timber under any form or type of contract whereby he retains an economic interest in such timber, the disposal under the contract shall be considered to be a sale of such timber. The difference between the amounts received for the timber in any taxable year and the adjusted basis for depletion of the timber with respect to which the amounts were so received shall be considered to be a gain or loss upon the sale of such timber for such year. If the taxpayer owned the timber for a period of more than six months prior to the date of such contract, for the purposes of section 117 (j) such timber shall be considered to be property used in the trade or business for the taxable year for which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1). Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from the sale of a capital asset held for more than six months will depend upon the application of section 117 (j) in the case of the taxpayer.

[T. D. 5394, 9 F. R. 9137]

§ 29.118–1 *Losses from wash sales of stock or securities.* (a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities, if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially indentical stocks or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer. See § 29.22 (a)–8 as to stock or securities sold from lots purchased at different dates or at different prices where the identity of the lots cannot be determined and § 29.113 (a) (10)–1 for the basis for determining gain or loss from the subsequent sale or other disposition of stock or securities acquired in connection with wash sales.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule:

The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule:

The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with

the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

Example (1). A, whose taxable year is the calendar year, on December 1, 1941, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1941, purchased 100 additional shares for $9,000. On January 2, 1942, he sold the 100 shares purchased on December 1, 1941, for $9,000. Because of the provisions of section 118 no loss from the sale is allowable as a deduction.

Example (2). A, whose taxable year is the calendar year, on September 21, 1941, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1941, he purchased 50 shares of substantially identical stock for $2,750, and on December 26, 1941, he purchased 25 additional shares of such stock for $1,125. On January 2, 1942, he sold for $4,000 the 100 shares purchased on September 21, 1941. There is an indicated loss of $1,000 on the sale of the 100 shares. Since within the 61-day period A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750—$3,000, or $750) is not allowable as a deduction because of the provisions of section 118. The loss on the sale of the remaining 25 shares ($1,250—$1,000, or $250) is deductible subject to the limitations provided in sections 24 (b) and 117. The basis of the 50 shares purchased December 21, 1941, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 2, 1942, is $2,500 (the cost of 50 of the shares sold on January 2, 1942), plus $750 (the difference between the purchase price of the 50 shares acquired on December 21, 1941 ($2,750), and the selling price of 50 of the shares sold on January 2, 1942 ($2,000)), or $3,250. Similarly the basis of the 25 shares purchased on December 26, 1941, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 2, 1942, is $1,250 plus $125, or $1,375. (See § 29.113 (a) (10)-1.)

Example (3). A, whose taxable year is the calendar year, on September 15, 1940, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1942, for $4,000. On each of the four days from February 15, 1942, to February 18, 1942, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1942, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1942, and the 50 shares purchased on February 16, 1942. In determining the period for which the 50 shares purchased on February 15, 1942, and the 50 shares purchased on February 16, 1942, were held, there is to be included the period for which the 100 shares purchased on September 15, 1940, and sold on February 1, 1942, were held.

§ 29.119-1 *Income from sources within the United States.* Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States. Citizens of the United States and domestic corporations entitled to the benefits of section 251 are, however, taxable upon income received within the United States, whether derived from sources within or without the United States. (See sections 212 (a), 231 (c), and 251.)

The Internal Revenue Code divides the income of such taxpayers into three classes:

(a) Income which is derived in full from sources within the United States;

(b) Income which is derived in full from sources without the United States; and

(c) Income which is derived partly from sources within and partly from sources without the United States.

The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.

§ 29.119-2 *Interest.* (a) There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations which are entitled to the benefits of section 251.

all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:

(1) Interest paid on deposits with persons, including individuals, partnerships, or corporations, carrying on the banking business, to persons (nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251) not engaged in business within the United States;

(2) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States (as determined under the provisions of section 119) for the 3-year period ending with the close of the taxable year of the payor which precedes the payment of such interest, or for such part of that period as may be applicable; and

(3) Income derived by a foreign central bank of issue from bankers' acceptances. A foreign central bank of issue means a bank which is by law or government sanction the principal authority (other than the government itself) issuing instruments intended to circulate as currency. Such banks are generally the custodians of the banking reserves of their countries.

(b) Any taxpayer who excludes from gross income from sources within the United States income of the type specified in paragraphs (a), (b), or (c) of this section shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified in those paragraphs.

(c) Interest received from the United States by a foreign corporation or a nonresident alien on a refund of Federal income taxes is taxable as income from sources within the United States.

(d) As to the inclusion in gross income of items received in the United States even though representing income from sources without the United States, in the case of citizens of the United States and domestic corporations entitled to the benefits of section 251, see § 29.251-2.

§ 29.119-3 *Dividends.* Gross income from sources within the United States includes dividends, as defined by section 115:

(a) From a domestic corporation other than one entitled to the benefits of section 251, and other than a corporation less than 20 percent of the gross income of which is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of section 119, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence); or

(b) From a foreign corporation unless the 50 percent of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends, or for such part of such period as it has been in existence, was derived from sources within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for the purposes of section 131, relating to credits for taxes of foreign countries and possessions of the United States, dividends from a foreign corporation shall be treated as income from sources without the United States.

Dividends will be treated as income from sources within the United States (except for the purposes of section 131) unless the taxpayer submits sufficient data to establish to the satisfaction of the Commissioner that they should be excluded from gross income under paragraph (a) or (b) of this section. (See also section 116 (f).)

§ 29.119-4 *Compensation for labor or personal services.* Except as provided in section 119 (a) (3), gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for

labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. Except as provided in section 119 (a) (3), wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

§ 29.119-5 *Rentals and royalties.* Gross income from sources within the United States includes rentals or royalties from property located within the United States or from any interest in such property, including rentals or royalties for the use of or the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States.

§ 29.119-6 *Sale of real property.* Gross income from sources within the United States includes gain, computed under the provisions of sections 111 to 113, inclusive, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see section 117.

§ 29.119-7 *Income from sources without the United States.* Gross income from sources without the United States includes:

(a) Interest other than that specified in section 119 (a) (1), as being derived from sources within the United States;

(b) Dividends other than those derived from sources within the United States as provided in section 119 (a) (2);

(c) Compensation for labor or personal services performed without the United States (for the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see § 29.119-4);

(d) Rentals or royalties derived from property without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property (see § 29.119-5); and

(e) Gain derived from the sale of real property located without the United States (see sections 111 to 113).

§ 29.119-8 *Sale of personal property.* Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold, except that income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. A possession of the United States constitutes a "country," within the meaning of this section, separate and distinct from the United States. Hence income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within a possession of the United States. The word "sold" includes "exchanged." The "country in which sold" ordinarily means the place where the property is marketed. This section does not apply to income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States or produced (in whole or in part) by the taxpayer without and sold within the United States. (See § 29.119-12.)

§ 29.119-9 *Deductions in general.* The deductions provided for in chapter 1 shall be allowed to nonresident alien individuals and foreign corporations engaged in trade or business within the United States, and to citizens of the United States and domestic corporations

entitled to the benefits of section 251, only if and to the extent provided in sections 213, 215, 232, 233, and 251.

§ 29.119-10 *Apportionment of deductions.* From the items specified in §§ 29.119-1 to 29.119-6, as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder shall be included in full as net income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Example: A nonresident alien individual engaged in trade or business within the United States whose taxable year is the calendar year derived gross income from all sources for 1942 of $180,000, including therein:

Interest on bonds of a domestic corporation	$9,000
Dividends on stock of a domestic corporation	4,000
Royalty for the use of patents within the United States	12,000
Gain from sale of real property located within the United States	11,000
Total	36,000

that is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under § 29.119-7.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000 is properly allocated to income from sources within the United States and the amount of $40,000 is property allocated to income from sources without the United States.

The remainder of the expenses, $30,000, cannot be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States.

§ 29.119-11 *Other income from sources within the United States.* (a) Items of gross income other than those specified in section 119 (a) and (c) shall be allocated or apportioned to sources within or without the United States, as provided in section 119 (e).

(b) The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in § 29.119-12.

(c) Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

§ 29.119-12 *Income from the sale of personal property derived from sources partly within and partly without the United States.* Items of gross income not allocated by § 29.119-1 to 29.119-8, inclusive, or § 29.119-11, to sources within or without the United States shall (unless unmistakably from a source within or a source without the United States) be treated as derived from sources partly within and partly without the United States. Such income derived from the sale of personal property may be divided into two classes: (1) Income derived from sources partly within the United States and partly within a foreign country, and (2) 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:

(1) Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a foreign country under one of the cases set forth in subdivisions (i)-(iii) of this subparagraph. As used in this subparagraph the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

(i) *Case 1 A.* Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all cases the basis of the accounting shall be fully explained in a statement attached to the return.

(ii) *Case 2 A.* Where an independent factory or production price has not been established as provided under Case 1 A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such net income shall be apporitioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. The term "gross sales of the taxpayer within the United States" means the gross sales made during the taxable year which were principally secured, negotiated, or effected by employees, agents, offices, or branches of the taxpayer's business resident or located in the United States. The term "gross sales" as used in this paragraph refers only to the sales of personai property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, and the term "property" includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the

taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

(iii) *Case 3 A.* Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed, the income derived from sources within the United States.

(b) The portion of such income derived from sources partly within the United States and partly within a possession of the United States which is attributable to sources within the United States shall be determined according to the following rules and cases:

(1) Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the cases set forth in subdivisions (i)–(iii) of this subparagraph. As used in this subparagraph the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

(i) *Case 1 B.* Same as paragraph (a) (1) (i) of this section.

(ii) *Case 2 B.* Where an independent factory or production price has not been established as provided under case 1 A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such net income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States

and its sale within the United States. The term "property" as used in this paragraph includes only the property held or used to produce income which is derived from such sales.

(iii) *Case 3 B.* Same as paragraph (a) (1) (iii) of this section.

(2) Gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within the United States and partly from sources within a possession of the United States under one of the following cases:

(i) *Case I B.* The net income shall first be computed by deducting from such gross income the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The amount of net income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such net income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States. The "business of the taxpayer" as that term is used in this paragraph shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

(ii) *Case II B.* Same as paragraph (a) (1) (iii) of this section.

§ 29.119-13 *Transportation service.* A foreign corporation carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(a) The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States should be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses should ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage, and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. Income, war-profits, and excess-profits taxes should not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and for such purpose, interest and other expenses for the use of borrowed capital should not be taken into the cost of services rendered, for the reason that the return upon the property used measures

the extent to which such borrowed capital is the source of the income. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the Internal Revenue Code should be taken.

The value of the property used should be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken should be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year. Current assets should be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries should be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries should be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States should be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries. For ships the average should be determined upon a daily basis for each ship and the amount to to apportioned for each ship as assets employed within the United States should be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(b) In computing net income from sources within the United States there shall be allowed as deductions from the gross income as determined in accordance with paragraph (a) of this section, (1) the expenses of the transportation business carried on within the United States as determined under paragraph (a) of this section, and (2) the expenses determined in accordance with paragraphs (c) and (d) of this section.

(c) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in paragraph (a) of this section; but for the purpose of computing net income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part (1) of all interest (deductible under section 23 (b)), and (2) of all income, war-profits, and excess-profits taxes (deductible under section 23 (c) and (d)), paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service.

(d) If a foreign corporation subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses (including taxes) properly apportioned or allocated to such other business should be excluded both from the deductions and from the apportionment process prescribed in paragraph (a) of this section; but, for the purpose of determining net income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income.

(e) Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax

liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process prescribed in paragraphs (a) to (d) of this section, the income derived from sources within the United States.

§ 29.119-14 *Telegraph and cable service.* A foreign corporation carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(a) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by adding (1) its gross revenues derived from messages originating in the United States and (2) amounts collected abroad on collect messages originating in the United States and deducting from such sum amounts paid or accrued for transmission of messages beyond the company's own circuit. Amounts received by the company in the United States with respect to collect messages originating without the United States shall be excluded from gross income.

(b) *Net income.* In computing net income from sources within the United States there shall be allowed as deductions from gross income determined in accordance with paragraph (a) of this section, (1) all expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States, (2) all direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables not including any amount already deducted in computing gross income), (3) depreciation of property (other than cables) located in the United States and used in the trade or business therein, and (4) a proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in subparagraphs (1), (2), and (3) of this paragraph) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise based on the ratio which the number of words originating in the United States bears to the total words transmitted by the enterprise.

§ 29.119-15 *Computation of income.* If a taxpayer has gross income from sources within or without the United States as defined by section 119 (a) or (c) together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated, and the net income from sources within the United States shall be separately computed therefrom.

§ 29.120-1 *Unlimited deduction for charitable and other contributions.* (a) Under the circumstances specified in section 120, the 15 percent limitation imposed by section 23 (o) on the deduction for charitable and other contributions is not applicable.

(b) In the case of a husband and wife making a joint return for any taxable year, the 15 percent limitation on the deduction for contributions or gifts imposed by section 23 (o) shall not be applicable if the aggregate amount of the contributions or gifts described in section 23 (o) (or corresponding provisions of prior Revenue Acts) made by the spouses in the taxable year and in each of the 10 preceding years, plus the aggregate amount of income, war-profits, or excess-profits taxes paid by the spouses during such year in respect of preceding taxable years, exceeds 90 percent of the aggregate net income of the spouses for each such year, as computed without the benefit of any deduction for contributions or gifts.

§ 29.122-1 *Net operating loss deduction*—(a) *General.* (1) Section 122 provides the rules for the computation of the net operating loss deduction allowed by section 23 (s). The net operating loss deduction is the aggregate of the net operating loss carry-overs and carry-backs to the taxable year, reduced by certain adjustments to prevent the deduction of losses absorbed by income not taxed.

(2) Section 122 provides that the aggregate of the net operating loss carry-overs and carry-backs to a taxable year shall be the basis of the net operating loss deduction. For the purpose of determining such carry-overs, the net operating loss for any taxable year may be carried over to the two succeeding tax-

able years. If the taxable year began on or after January 1, 1942, the net operating loss for such taxable year may also be carried back to the two preceding taxable years, not considering as a preceding taxable year any year which began before January 1, 1941. The amount of the net operating loss which may be carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed by the net income for the other taxable years, preceding such taxable year, to which it was carried back or carried over. If the net operating losses for several taxable years are carried back or carried over to one taxable year, they are considered to be applied in reduction of the net income for such taxable year in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year. Therefore, the net operating loss carry-overs to a taxable year beginning on or after January 1, 1942, are the net operating loss for the first preceding taxable year and so much of the net operating loss for the second preceding taxable year as has not been absorbed by the net income (computed under section 122), if any, for the first preceding taxable year, and the net operating loss carry-backs to such a taxable year are the net operating loss for the second succeeding taxable year and so much of the net operating loss for the first succeeding taxable year, as has not been absorbed by the net income (computed under section 122), if any, for the first preceding taxable year. If either of the taxable years preceding the taxable year for which the deduction is allowed began on or after January 1, 1942, the net operating loss for such preceding taxable year is first reduced to the extent it has been absorbed by the net income (computed under section 122), if any, for the taxable years to which such loss has been carried back.

(3) A fractional part of a year which is a taxable year under section 48 (a) is a preceding or succeeding taxable year for the purpose of determining under section 122 the first, second, or third preceding taxable year or the first or second succeeding taxable year.

(4) Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(b) *Steps in computation of net operating loss deduction.* There are three steps in the ascertainment of the net operating loss deduction. The first step is the computation of the net operating loss, if any, for the two preceding taxable years and for the two succeeding taxable years. The second is the computation of the net operating loss carry-overs to the taxable year from such preceding taxable years and the computation of the net operating loss carry-backs to the taxable year from such succeeding taxable years. The third is the conversion of the aggregate of such net operating loss carry-overs and carry-backs into the net operating loss deduction.

(c) *Ascertainment of deduction dependent upon net operating loss carry-back.* If the taxpayer is entitled in computing his net operating loss deduction to a carry-back which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on the return without regard to such net operating loss carry-back. When the taxpayer ascertains the net operating loss carry-back, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carry-back. Under the provisions of section 3771 (e), no interest is allowed with respect to any such overpayment for the period prior to the filing of the claim for credit or refund of such overpayment or prior to the filing of a petition with The Tax Court of the United States asserting such overpayment, whichever is earlier. If the taxpayer files a claim based upon the overpayment caused by a carry-back from the first succeeding taxable year, and later ascertains that he is entitled to a carry-back from the second succeeding taxable year, he should file a second claim for credit or refund based on the overpayment, if any, caused by the failure to take into account the carry-back from such second succeeding taxable year.

§ 29.122-2 *Computation of net operating loss in case of corporation.* A net operating loss is sustained by a corpora-

tion in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions, additions, and limitations:

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

(b) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(c) No net operating loss deduction shall be allowed;

(d) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of long-term capital losses shall not exceed the amount includible on account of long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of short-term capital gains. For any taxable year beginning after December 31, 1941, the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of such assets; and

(e) For taxable years beginning after December 31, 1941, there shall be allowed as a deduction the amount of excess profits tax imposed by subchapter E of chapter 2 paid or accrued within the taxable year, subject, however, to the provisions of section 122 (d) (6) (A), (B), and (C).

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

Example. For the year 1942 the X Corporation, which makes its income tax returns on the calendar year basis, has gross income as defined in section 22 of $400,000 and deductions allowed by section 23 of $600,000, exclusive of any net operating loss deduction. Included in gross income are long-term capital gains of $50,000 and short-term capital gains of $25,000. The corporation had long-term capital losses of $60,000 and short-term capital losses of $35,000 which are deductible to the extent of the capital gains, or $75,000. The X Corporation also deducted $75,000 for depletion on a percentage basis. If depletion had been computed without reference to percentage depletion, the amount of such deduction would have been $5,000. For 1942 the X Corporation also had $35,000 of wholly tax-exempt interest, and paid $15,000 in interest on indebtedness incurred to carry the obligations from which such tax-exempt interest was derived.

On the basis of these facts the X Corporation has a net operating loss for the year 1942 of $110,000, computed as follows:

(1) Deductions for 1942		$600,000
Less:		
(2) Excess of percentage depletion over cost ($75,000 minus $5,000)		70,000
(3) Deductions adjusted as required by section 122 (d) (item (1) minus item (2))		530,000
(4) Gross income for 1942	$400,000	
(5) Plus tax-exempt interest minus interest paid ($35,000 minus $15,000)	20,000	
(6) Gross income adjusted as required by section 122 (d) (item (4) plus item (5))		420,000
(7) Net operating loss for 1942 (item (3) minus item (6))		110,000

§ 29.122-3 *Computation of net operating loss in case of a taxpayer other than a corporation*—(a) *General.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions and limitations:

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

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) Long-term capital gains and long-term capital losses shall be taken into account without regard to the percentage provisions of section 117 (b);

(5) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of business long-term and short-term capital losses shall not exceed the amount includible on account of the business long-term and short-term capital gains, respectively, plus an allocable portion of any nonbusiness long-term and short-term capital gains, computed in accordance with paragraph (c) of this section; and for any taxable year beginning after December 31, 1941, the amount deductible on account of business capital losses shall not exceed the amount includible on account of business capital gains, plus a portion of any nonbusiness capital gains, computed in accordance with paragraph (c) of this section;

(6) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on account of nonbusiness long-term and short-term capital losses shall not exceed the amount includible on account of nonbusiness long-term and short-term capital gains, respectively, and for any taxable year beginning after December 31, 1941, the amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains: and

(7) Ordinary nonbusiness deductions (i. e., exclusive of capital losses) shall be allowed only to the extent of the amount of ordinary nonbusiness gross income (i. e., exclusive of capital gains), plus (i) for any taxable year beginning after December 31, 1938, and before January 1, 1942, the excess, if any, of nonbusiness long-term and short-term capital gains over nonbusiness long-term and short-term capital losses, respectively, and (ii) for any taxable year beginning after December 31, 1941, the excess, if any, of nonbusiness capital gains over nonbusiness capital losses.

(b) *Treatment of carry-overs*—(1) *Taxable years beginning before 1943.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has, for any taxable year beginning after December 31, 1938, and before January 1, 1943, a net short-term capital loss carry-over from the preceding taxable year, includible among his short-term capital losses for the current taxable year by virtue of section 117 (e), must determine how much of such net short-term capital loss carry-over is a business and how much is a nonbusiness short-term capital loss. In order to make this determination, the taxpayer must first ascertain what proportion of the net short-term capital loss for the preceding taxable year was attributable to an excess of business short-term capital losses over business short-term capital gains for such year, and what proportion was attributable to an excess of nonbusiness short-term capital losses over nonbusiness short-term capital gains. The same proportions of the net short-term capital loss carry-over from such preceding taxable year shall be treated as a business short-term capital loss and a nonbusiness short-time capital loss, respectively.

(i) This subparagraph may be illustrated by the following examples:

Example (1). Without considering any short-term capital loss carry-over to the taxable year 1941. A, an individual, has the following short-term capital gains and losses for such taxable year:

Business short-term capital gains of $1,000 and nonbusiness short-term capital gains of $500, business short-term capital losses of $1,600 and nonbusiness short-term capital losses of $600. A's net short-term capital loss for the taxable year 1941 is $700, computed as follows:

Short-term capital losses ($1,600 plus $600)	$2,200
Less: Short-term capital gains ($1,000 plus $500)	1,500
Net short-term capital loss for 1941	700

Since the business short-term capital losses exceeded the business short-term capital gains by $600 ($1,600 minus $1,000), $600 of the $700 net short-term capital loss is attributable to such excess. Similarly, $100 is attributable to an excess of nonbusiness short-term capital losses over nonbusiness short-term capital gains. Assuming that the net short-term capital loss carry-over to 1942 from 1941 is also $700, then the same amounts will be treated as business and nonbusiness short-term capital losses, respectively, i. e., $600 will be treated as a business short-term capital loss and $100 as a nonbusiness short-term capital loss.

Example (2) Assume the same facts as in the previous example except that the net short-term capital loss carry-over to 1942 from 1941 is only $350, because of the limitations contained in section 117 (e). Since six-sevenths ($600) of the $700 net short-term capital loss for 1941 was attributable to an excess of business short-term capital

losses over gains and one-seventh ($100) was attributable to an excess of nonbusiness short-term capital losses over gains, six-sevenths, of $300, of the $350 short-term capital loss carry-over from 1941 to 1942 shall be treated as a business short-term capital loss, and one-seventh, or $50, shall be treated as a nonbusiness short-term capital loss.

(2) *Taxable years beginning after December 31, 1942.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has, for any taxable year beginning after December 31, 1942, a net capital loss carry-over from preceding taxable years, includible among the short-term capital losses for the current taxable year by virtue of section 117 (e), must determine how much of such net capital loss carry-over is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer must first ascertain what proportion of the net capital losses for such preceding taxable years was attributable to an excess of business capital losses over business capital gains for such years, and what proportion was attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. The same proportion of the net capital loss carry-over from any such preceding taxable years shall be treated as a business capital loss and a nonbusiness capital loss, respectively.

(i) The effect of this subparagraph may be illustrated by the following example:

Example. A, an individual, has the following short-term gains and losses for the calendar year 1943: Business short-term capital gains of $1,000 and nonbusiness short-term capital gains of $500, business short-term capital losses of $1,600 and nonbusiness short-term capital losses of $600, business long-term capital gains of $1,000 and nonbusiness long-term capital gains of $500, business long-term capital losses of $1,600 and nonbusiness long-term capital losses of $600. A's net capital loss for the taxable year 1943 is $1,400, computed as follows:

Short-term capital losses ($1,600 plus $600)		$2,200
Long-term capital losses ($1,600 plus $600)		2,200
Total capital losses		4,400
Short-term capital gains ($1,000 plus $500)	$1,500	
Long-term capital gains $1,000 plus $500)	1,500	
Total capital gains		3,000
Net capital loss for 1943		1,400

Since business capital losses exceeded business capital gains by $1,200 ($3,200 minus $2,000), $1,200 of the $1,400 net capital loss is attributable to such excess. Similarly, $200 is attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. Assuming that the net capital loss carry-over to 1944 from 1943 is also $1,400, then the same amounts will be treated as business and nonbusiness capital losses, respectively, i. e., $1,200 will be treated as a business capital loss and $200 as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses*—(1) *Taxable years beginning before 1942.* In the computation of a net operating loss a taxpayer other than a corporation must, for taxable years beginning after December 31, 1938, and before January 1, 1942, first use his nonbusiness long-term and short-term capital gains for the deduction of his nonbusiness long-term and short-term capital losses, respectively. See paragraph (a) (6) of this section. Any amounts not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. See paragraph (a) (7) of this section. The remainders, computed by applying the excess ordinary nonbusiness deductions proportionately against the excess long-term and excess short-term capital gains, shall be treated as long-term and short-term capital gains, respectively, and may be used for the purpose of determining the deductibility of business long-term and short-term capital losses under paragraph (a) (5) of this section.

Example. A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Long-term capital gains	6,000
Short-term capital gains	7,000
Total gross income	20,500

He also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Long-term capital losses	2,000
Short-term capital losses	5,000
Total deductions	16,000

In order to determine the portion of the nonbusiness long-term and short-term capital gains available for the deduction of business long-term and short-term capital losses there must first be deducted the amounts of the nonbusiness long-term and short-term

capital losses, respectively. It is then found that the excess long-term capital gains amount to $4,000 ($6,000 minus $2,000), and the excess short-term capital gains to $2,000 ($7,000 minus $5,000). Since the ordinary nonbusiness deductions exceed the ordinary nonbusiness gross income by $1,500 ($9,000 minus $7,500), $1,500 of the $4,000 excess long-term and $2,000 excess short-term capital gains must be used to permit the allowance of such $1,500 under paragraph (a) (7) of this section. Two-thirds of the $1,500 excess of ordinary deductions over ordinary gross income, i. e., $1,000, will therefore be deducted from the $4,000 of excess long-term capital gains, leaving $3,000 to be added to the business long-term capital gains for the purpose of determining the deductibility of any business long-term capital losses. Similarly, one-third of the $1,500 excess of ordinary deductions over ordinary gross income, i. e., $500 will be deducted from the $2,000 excess short-term capital gains, leaving $1,500 to be added to the business short-term capital gains, for the purpose of determining the deductibility of any business short-term capital losses.

(2) *Taxable years beginning after December 31, 1941.* In the computation of a net operating loss a taxpayer other than a corporation must, for taxable years beginning after December 31, 1941, use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. See paragraph (a) (6) of this section. Any amounts not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. See paragraph (a) (7) of this section. The remainders, computed by applying the excess ordinary nonbusiness deductions against the excess capital gains, shall be treated as capital gains and may be used for the purpose of determining the deductibility of business capital losses under paragraph (a) (5) of this section.

Example. A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Long-term capital gains	6,000
Short-term capital gains	7,000
Total gross income	20,500

He also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Long-term capital losses	2,000
Short-term capital losses	5,000
Total deductions	16,000

In order to determine the portion of the nonbusiness capital gains available for the deduction of business capital losses there must first be deducted the amounts of the nonbusiness capital losses. It is then found that the excess capital gains amount to $6,000 ($13,000 minus $7,000). Since the ordinary nonbusiness deductions exceed the ordinary nonbusiness gross income by $1,500 ($9,000 minus $7,500), $1,500 of the $6,000 excess capital gains must be used to permit the allowance of such $1,500 under paragraph (a) (7) of this section. Therefore, $1,500 excess of ordinary deductions over ordinary gross income will be deducted from the $6,000 of excess capital gains, leaving $4,500 to be added to the business capital gains for the purpose of determining the deductibility of any business capital loss.

(d) *Illustration of computation of net operating loss by a taxpayer other than a corporation.* (1) A, an individual who makes his income tax returns on a calendar year basis, has gross income of $483,000 and deductions (exclusive of a net operating loss deduction) of $600,000 for 1942. Included in gross income are business long-term capital gains (as defined in section 117 (a) (4)) of $25,000 (amount of actual gain $50,000) on assets held for more than 24 months, and nonbusiness income of $10,000. Included among the deductions are a business long-term capital loss (as defined in section 117 (a) (5)) of $30,000 (amount of actual loss $60,000) on a capital asset held for 19 months, and deductions incurred in transactions not connected with a trade or business of $12,000. A has no other items of income or deductions to which section 122 (d) is applicable.

(2) On the basis of these facts A has a net operating loss for 1942 of $110,000, computed as follows:

(1) Deductions for 1942, exclusive of capital losses ($600,000 minus $30,000)		$570,000
(2) Plus amount of actual capital loss ($60,000) to extent such amount does not exceed actual capital gains ($50,000)		50,000
(3) Sum of items (1) and (2)		620,000
(4) Less excess of nonbusiness deductions over nonbusiness income ($12,000 minus $10,000)		2,000
(5) Deductions adjusted as required by section 122 (d) (item (3) minus item (4))		618,000
(6) Gross income for 1942	$483,000	
(7) Plus excess of long-term capital gains actually realized over amount previously taken into account ($50,000 minus $25,000)	25,000	

(8) Gross income adjusted as required by section 122 (d) (item (6) plus item (7))	$508,000
(9) Net operating loss for 1942 (item (5) minus item (8))	110,000

(3) For treatment of depletion deductions and tax-free interest, see example in § 29.122-2. For treatment of net short-term capital loss carry-over, net capital loss carry-over, nonbusiness capital gains and losses, and the portion of the nonbusiness capital gains which may be used to permit the deduction of business capital losses, see examples in paragraphs (b) and (c) of this section.

(e) *Joint return by husband and wife.* In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed upon the basis of the combined income and deductions of both spouses, and the exceptions and limitations prescribed by section 122 (d) are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

§ 29.122-4 *Computation of net operating loss carry-overs and net operating loss carry-backs*—(a) *In general.* (1) The aggregate of any net operating loss carry-overs and any net operating loss carry-backs to a taxable year shall be the basis of the net operating loss deduction. In order to compute such deduction, the taxpayer must first determine the part of any net operating losses for the two preceding taxable years which are carry-overs to the current taxable year, and the part of any net operating losses for the two succeeding taxable years which are carry-backs to the current taxable year.

(2) Under section 122 the net operating loss for any taxable year beginning on or after January 1, 1942, may be carried back to the two preceding taxable years (except any such taxable year which began before January 1, 1941) and may be carried over to the two succeeding taxable years. The net operating loss for any taxable year beginning before January 1, 1942, may be carried over to the two succeeding taxable years, regardless of whether such year begins before, on, or after January 1, 1941. The amount which is so carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the net income for other taxable years, preceding such taxable year, to which it was carried back or carried over. For the purpose of determining the net income for a taxable year which so absorbs the net operating loss that is carried back or carried over, the various net operating loss carry-overs and carry-backs to such taxable year are considered to be applied in reduction of the net income for such taxable year in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(b) *Portion of net operating loss which is a carry-over or a carry-back to the current taxable year.* (1) The net operating loss sustained in any taxable year beginning before January 1, 1942, may be carried over to the two succeeding taxable years. The entire net operating loss may be carried over to the first succeeding taxable year, and the carry-over to the second succeeding taxable year is the excess of the net operating loss over the net income, if any, for the first succeeeding taxable year (computed as provided in paragraph (c) of this section). For example, the taxpayer had a net operating loss of $10,000 in 1940. It had a 1941 net income of $6,000 (computed as provided in paragraph (c) of this section). The carry-over from 1940 to 1942 is $4,000, the excess of the $10,000 loss over the $6,000 net income for 1941.

(2) The net operating loss sustained in any taxable year beginning on or after January 1, 1942, may be carried back to the two preceding taxable years (not considering as a preceding taxable year a year beginning prior to January 1, 1941) and may be carried over to the two succeeding taxable years. The entire net operating loss may be carried back to the second preceding taxable year. However, if the second preceding taxable year began before January 1, 1941, no part of the net operating loss may be carried back to such taxable year, and the net income for such taxable year does not reduce the amount of the net operating loss which may be carried back or carried over to the other taxable years. The net operating loss, to the extent it exceeds the net income, if any (computed as provided in paragraph (c) of this section), for the second preceding taxable year, may then be carried back to the first preceding taxable year. To the extent that the net operating loss exceeds the aggregate of the net income, if any (computed as provided in paragraph (c) of this section), for the two preceding taxable years, it may be carried over to

the first succeeding taxable year. To the extent that the net operating loss exceeds the aggregate of the net income, if any (computed as provided in paragraph (c) of this section), for the two preceding taxable years and for the first succeeding taxable year, it may be carried over to the second succeeding taxable year.

Example. The taxpayer has a net operating loss of $100,000 in 1943. It has net income (computed as provided in paragraph (c) of this section) as follows: $10,000 in 1941, $15,000 in 1942, $35,000 in 1944, and $60,000 in 1945. The net operating loss carry-back from 1943 to 1941 is $100,000, an amount equal to the full operating loss. The carry-back to 1942 is $90,000, the excess of the $100,000 net operating loss over the $10,000 net income for 1941 (computed as provided in paragraph (c) of this section). The carry-over to 1944 is $75,000, the excess of the $100,000 net operating loss over the aggregate of the $10,000 net income for 1941 and the $15,000 net income for 1942 (computed in each instance as provided in paragraph (c) of this section). The carry-over to 1945 is $40,000, the excess of the $100,000 net operating loss over the aggregate of the $10,000 net income for 1941, the $15,000 net income for 1942, and the $35,000 net income for 1944 (computed in each instance as provided in paragraph (c) of this section).

(c) *Computation of net income which is subtracted from net operating loss to determine carry-back or carry-over.* The net income for any taxable year which is subtracted from the net operating loss for another taxable year to determine the portion of such net operating loss which is a carry-back or carry-over to a particular taxable year as provided in paragraph (b) of this section is computed with the following adjustments:

(1) The net operating loss deduction for such taxable year is computed by taking into account only such net operating losses otherwise allowable as carry-overs or carry-backs to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the net income is to be deducted.

Example. In computing the net operating loss deduction for 1945, the taxpayer has a carry-over from 1943 of $9,000, a carry-over from 1944 of $6,000, a carry-back from 1946 of $18,000, and a carry-back from 1947 of $14,000, or an aggregate of $47,000 in carry-overs and carry-backs which is the basis for the deduction. In computing the net income for 1945 which is deducted from the net operating loss for 1946 in order to determine the portion of such net operating loss which may be carried over to 1947 or 1948, the net operating loss deduction for 1945 is computed without taking into account the $18,000 carry-back from 1946 or the $14,000 carry-back from 1947. The net operating loss deduction for 1945 is, for the purposes of such computation, the aggregate of the $9,000 carry-over from 1943 and the $6,000 carry-over from 1944, or $15,000, adjusted as provided in § 29.122-5 (relating to the conversion of the aggregate or the net operating loss carry-overs and carry-backs to the taxable year into the net operating loss deduction).

In computing the net income for 1945 which is deducted from the net operating loss for 1947 in order to determine the portion of such loss which may be carried back to 1946 and carried over to 1948 and 1949, the net operating loss deduction for 1945 is computed without taking into account the $14,000 carry-back from 1947, and as so computed is the aggregate of the $9,000 carry-over from 1943, the $6,000 carry-over from 1944, and the $18,000 carry-back from 1946, or $33,000, adjusted as provided in § 29.122-5.

(2) In the case of a corporation, the net income shall be computed in accordance with the exceptions, additions, and limitations applicable in the computation of a net operating loss (see § 29,122-2), except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) of this paragraph.

(3) In the case of a taxpayer other than a corporation, the net income and adjusted gross income for taxable years beginning after December 31, 1943, shall be computed in accordance with the first four exceptions, additions, and limitations specified in § 29.122-3 (a), except that the net operating loss deduction shall be allowed to the extent provided in subparagraph (1) of this paragraph. In lieu of the last three exceptions specified in § 29.122-3 (a), the taxpayer is required only (i) for a taxable year beginning before January 1, 1942, to restrict the amount of his deductions for long-term and short-term capital losses to the amount of his long-term and short-term capital gains, respectively, and (ii) for a taxable year beginning on or after January 1, 1942, to restrict the amount of his deduction for capital losses to the amount of his capital gains. The ordinary nonbusiness deductions are allowed in full if otherwise allowable by law. The exceptions and limitations dependent upon the distinction between business and nonbusiness items of gross income and deductions are not applicable in the computation of the net income to be

subtracted in computing carry-backs and carry-overs.

(4) Any deduction which is limited in amount to a percentage of the taxpayer's net income, or adjusted gross income for taxable years beginning after December 31, 1943, shall be recomputed upon the basis of the net income or adjusted gross income, as the case may be, determined with the adjustments prescribed in subparagraph (3) of this paragraph.

(5) The net income, as adjusted, shall in no case be considered less than zero.

(d) *Illustration of computation of net operating loss carry-backs and carry-overs.* The application of this section may be illustrated by the following example:

Example. The taxpayer is a corporation making its income tax returns on the calendar year basis. It had no net operating loss in 1939 or 1940, or in 1948 or 1949. Its net income, computed without any net operating loss deduction (it being assumed that none of the other adjustments provided in paragraph (c) of this section is applicable), was $20,000 in 1941, $35,000 in 1942, $30,000 in 1946, and $85,000 in 1947. It sustained net operating losses as follows: $25,000 in 1943, $50,000 in 1944, and $40,000 in 1945. It assumed for the purposes of this example that the application of § 29.122–5 does not cause any reduction of the amount of the aggregate of the net operating loss carry-overs and carry-backs to any taxable year, so that such aggregate is the net operating loss deduction for such taxable year.

(1) The portions of the $25,000 net operating loss for 1943 which may be used as carry-backs to 1941 and 1942 and as carry-overs to 1944 and 1946 are computed as follows:

(a) For 1941, the carry-back is $25,000, that is, the amount of the net operating loss.

(b) For 1942, the carry-back is $5,000, that is, the excess of the $25,000 net operating loss over the $20,000 net income for 1941 (such net income being determined without any net operating loss deduction since there is no carry-over to 1941 from 1939 or 1940 and no carry-back from 1942, and the carry-back from 1943 is not taken into account).

(c) For 1944 and 1945, there is not carry-over of the net operating loss for 1943 since such loss does not exceed $55,000, the sum of the net incomes for the two taxable years preceding 1943 computed as provided in paragraph (c) of this section (the $20,000 net income for 1941 and the $35,000 net income for 1942, there being no net operating loss deduction for either taxable year since the carry-backs from 1943 and from 1944 are not taken into account).

(2) The portions of the $50,000 net operating loss from 1944 which may be used as carry-backs to 1942 and 1943 and as carry-overs to 1945 and 1946 are computed as follows:

(a) For 1942, the carry-back is $50,000, that is, the amount of the net operating loss.

(b) For 1943, the carry-back is $20,000, that is, the excess of the $50,000 net operating loss over the $30,000 net income for 1942 (the $35,000 income for 1942 reduced by the $5,000 carry-back from 1943, the carry-back from 1944 not being taken into account).

(c) For 1945, the carry-over is $20,000, that is, the excess of the $50,000 net operating loss over $30,000, the sum of the $30,000 net income for 1942 (computed with the deduction of the $5,000 carry-back from 1943 and without the deduction of the carry-back from 1944) and the $0 net income for 1943 (a year in which a net operating loss was sustained).

(d) For 1946, the carry-over is $20,000, that is, the excess of the $50,000 net operating loss over $30,000, the sum of the $30,000 net income for 1942 (computed with the deduction of the $5,000 carry-back from 1943 and without the deduction of the carry-back from 1944) and the $0 net income for 1943 and 1945 (years in which net operating losses were sustained).

(3) The portions of the $40,000 net operating loss for 1945 which may be used as carry-backs to 1943 and 1944 and as carry-overs to 1946 and 1947 are computed as follows:

(a) For 1943, the carry-back is $40,000, that is, the amount of the net operating loss.

(b) For 1944, the carry-back is $40,000, that is, the excess of the $40,000 net operating loss for 1945 over $0, the net income for 1943 (a year in which a net operating loss was sustained).

(c) For 1946, the carry-over is $40,000, that is, the excess of the $40,000 net operating loss for 1945 over $0, the sum of the net incomes for 1943 and 1944 (years in which net operating losses were sustained).

(d) For 1947, the carry-over is $30,000 that is, the excess of the $40,000 net operating loss for 1945 over $10,000, the sum of the $0 net incomes for 1943 and 1944 and the $10,000 net income for 1946 (such net income for 1946 being computed as the $30,000 income reduced by the net operating loss carry-over of $20,000 from 1944, the $40,000 carry-over to 1946 from 1945 not being taken into account).

For 1941, the net operating loss deduction is determined to be $25,000, that is, the carry-back from 1943.

For 1942, the net operating loss deduction is determined to be $55,000, that is, the aggregate of the carry-back of $5,000 from 1943 and of the carry-back of $50,000 from 1944.

For 1946, the net operating loss deduction is determined to be $60,000, that is, the aggregate of the $20,000 carry-over from 1944 and the $40,000 carry-over from 1945.

For 1947, the net operating loss deduction is determined to be $30,000, that is, the carry-over from 1945.

(e) *Joint return by husband and wife.* If a husband and wife making a joint return for any taxable year did not make a joint return for any of the taxable years involved in the computation of a net operating loss carry-over or a net operating loss carry-back to the taxable year for which the joint return is made, such separate net operating loss carry-over or separate net operating loss carry-back is a joint net operating loss carry-over or joint net operating loss carry-back to such taxable year.

If a husband and wife making a joint return for a taxable year made a joint return for each of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back to such taxable year, the joint net operating loss carry-over or joint net operating loss carry-back to such taxable year is computed in the same manner as the net operating loss carry-over or net operating loss carry-back of an individual under the provisions of this section but upon the basis of the joint net operating losses and the combined net income of both spouses.

If a husband and wife making separate returns for a taxable year made a joint return for any or all of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back, the separate net operating loss carry-over or separate net operating loss carry-back of each spouse to the taxable year is computed in the manner set forth in the preceding paragraph of this section, but with the following exceptions and limitations:

(1) The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be the portion of the joint net operating loss (computed in accordance with § 29.122-3 (e) attributable to the gross income and deductions of such spouse, both gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(2) The net income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such net income was reported in a joint return, the sum of the following:

(i) The portion of the combined net income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, both gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined net income, and

(ii) The portion of such combined net income attributable to the other spouse, but if such other spouse has a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the net income is subtracted, and if such other spouse sustained a net operating loss in such taxable year, then such portion shall first be reduced by such net operating loss of such other spouse. However, such net operating loss of such other spouse shall first be diminished by the excess, if any, of the reduction provided in section 122 (c) for the year in which the net income was realized over the aggregate of the net operating loss carry-overs and net operating loss carry-backs which are taken into account in computing the net operating loss deduction for such taxable year (see (*b*) of the next sentence).

For the purposes of (i) and (ii) of this subparagraph, the combined net income shall be computed as though the combined income and deductions of both spouses were those of one individual, and in such computation:

(*a*) The exceptions, additions, and limitations provided in section 122 (d) (1), (2), and (4) shall apply, and

(*b*) The net operating loss deduction shall be determined without taking into account any net operating loss of either spouse or any joint net operating loss of both spouses which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in which the particular spouse sustained the net operating loss from which the net income is subtracted.

In the following examples, which illustrate subparagraphs (1) and (2) of this paragraph, it is assumed that there are no items of adjustment under section 122 (d) (1), (2), and (4), and the net income or loss in each case is the net income or loss determined without any net operating loss deduction. The taxpay-

ers in each example, H, a husband, and W, his wife, report their income on the calendar year basis.

Example (1). H and W filed joint returns for 1941 and 1942. They sustained a joint net operating loss of $1,000 for 1941 and a joint net operating loss of $2,000 for 1942. For 1941, the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1941 is considered the net operating loss of H for 1941, and $300 of such joint net operating loss is considered the net operating loss of W for 1941. For 1942 the gross income of H exceeded his deductions, so that his seperate net income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1942 is considered the separate net operating loss of W for 1942.

Example (2). H and W filed joint returns for 1939 and 1941, and separate returns for 1940 and 1942. For such years they had net incomes and net operating losses as follows:

	1939	1940	1941	1942
H	[1] $5,000	[1] $2,500	[2] $6,500	[1] $4,000
W	[1] 3,000	[2] 2,000	[2] 3,000	[1] 1,500
	[3] 8,000	----------	[4] 9,500	----------

[1] Loss. [2] Income. [3] Joint loss. [4] Combined income.

The net operating loss carry-over of H from 1942 to 1943 is $4,000, that is, his $4,000 net operating loss for 1942 which is not reduced by any part of the net income for 1941, since none of such net income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss deduction for her taxable year 1942, which taxable year begins on the same date as H's taxable year 1942. The determination of the amount ($0) of net income for 1941 which reduces H's net operating loss for 1942 is made as follows:

The combined net income of $9,500 for 1941 is reduced to $1,000 by the net operating loss deduction for such year of $8,500. This net operating loss deduction is computed without taking into account any net operating loss sustained in a taxable year beginning on or after January 1, 1942, the date of the beginning of the taxable year in which H sustained the net operating loss which is a carry-over to 1943. This $8,500 amount is composed of H's carry-overs of $5,000 from 1939 and $2,500 from 1940, or a total of $7,500, and of W's carry-over of $1,000 from 1939 (the excess of W's $3,000 loss for 1939 over her $2,000 income for 1940). None of the $1,000 combined net income for 1941 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carry-over) offsetting H's loss (computed by deducting from his income his separate carry-overs). No part of the $1,000 net income for 1941 which is attributable to W is used to reduce H's net operating loss for 1942 since such net income attributable to W must first be reduced by W's $1,500 net operating loss for 1942, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the net income is subtracted.

The net operating loss carry-over of W from 1942 to 1943 is $500, her $1,500 loss reduced by the $1,000 net income for 1941, computed in the manner prescribed in the preceding paragraph, since all of such net income is attributable to her.

Example (3). Assume the same facts as in example (2), except that for 1942 the net operating loss of W is $200 instead of $1,500.

The net operating loss carry-over of H from 1942 to 1943 is $3,200, that is, his $4,000 net operating loss reduced by $800 of the net income for 1941, computed as follows:

The combined net income for 1941, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 net income attributable to H there is added $800, the excess of the $1,000 net income attributable to W over her $200 net operating loss sustained in 1942, a taxable year beginning on the same date (January 1, 1942) as the taxable year of H (1942) in which he sustained the $4,000 net operating loss from which the net income is subtracted. See paragraph (2) (ii) above.

W has no net operating loss carry-over from 1942 to 1943 since her net operating loss of $200 for 1942 does not exceed the $1,000 net income for 1941 attributable to her.

Example (4). Assume the same facts as in example (2) except that W changes her accounting period in 1942 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1942, to January 31, 1942, but has a net operating loss of $200 for the fiscal year February 1, 1942, to January 31, 1943.

The net operating loss carry-over of H from 1942 to 1943 is $3,000, that is, his net operating loss of $4,000 for 1942 reduced by the $1,000 net income for 1941, computed as follows:

The combined net income for 1941, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 net income attributable to H there is added the $1,000 net income attributable to W. The net income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1942, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which the net income is deducted.

The net operating loss carry-over of W from the fiscal year beginning February 1, 1942, to her next fiscal year is $200, her net operating loss for such year. This net operating loss is not reduced by any amount of net income for 1941, since there is no net income for 1941 when computed for the purpose of determining the carry-over of W's net operating loss for her fiscal year beginning February 1, 1942. For such purpose, the net income of $9,500 for 1941 is reduced to $0 by the net operating loss deduction for such year of $12,500, computed without taking into account any net operating loss sustained in a taxable year beginning on or after February 1, 1942, the date of the beginning of the taxable year in which W sustained the net operating loss which is the basis for the carry-over. This $12,500 amount is composed of H's carry-overs of $5,000 from 1939 and $2,500 from 1940, and his carry-back of $4,000 from 1942 (the calendar year beginning January 1, 1942), and of W's carry-over of $1,000 from 1939 (the excess of her $3,000 loss for 1939 over her $2,000 income for 1940).

If a husband and wife making a joint return for any taxable year made a joint return for one or more but not all of the taxable years involved in the computation of a net operating loss carry-over or net operating loss carry-back to such taxable year, such net operating loss carry-over or net operating loss carry-back to the taxable year is computed in the manner set forth in subparagraphs (1) and (2) of this paragraph. Such net operating loss carry-over or net operating loss carry-back is considered a joint net operating loss carry-over or joint net operating loss carry-back to such taxable year. For example, if in examples (2) and (3) of this paragraph a joint return was filed for 1943, the same amounts computed in those examples as carry-overs of H and W to that year would be the amounts considered joint net operating loss carry-overs to that year.

The joint net operating loss carry-overs and joint net operating loss carry-backs to any taxable year for which joint return is made are all the net operating loss carry-overs and net operating loss carry-backs of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1943. The wife filed a separate return for the calendar years 1941 and 1942, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1942, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1942. The husband sustained net operating losses in both such taxable periods. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carry-overs to 1943 from 1941 and 1942 (see the preceding paragraphs of this section), the joint net operating loss carry-overs to 1943 are the separate net operating loss carry-overs of the wife from the calendar years 1941 and 1942 and the separate net operating loss carry-overs of the husband from the fiscal year ending June 30, 1942, and from the short taxable year ending December 31, 1942. If the husband and wife also filed joint returns for the calendar years 1944 and 1945, having joint net income in 1944 and a joint net operating loss in 1945, the joint net operating loss carry-back to 1943 from 1945 is computed upon the basis of the joint net operating loss for 1945, since separate returns were not made for any taxable year involved in the computation of such carry-back.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5600, 13 F. R. 577]

§ 29.122-5 *Conversion of net operating loss carry-over into net operating loss deduction.* (a) The net operating loss deduction for any taxable year is the aggregate of the net operating loss carry-overs and carry-backs to such taxable year computed as prescribed in § 29.122-4, reduced by the excess of the net income for such taxable year (computed in the same manner as the net income is computed for the purposes of § 29.122-4 except that no net operating loss deduction shall be taken into account and no deduction for excess profits tax imposed by subchapter E of chapter 2 shall be taken into account) over:

(1) In the case of a taxpayer other than a corporation, the net income computed without regard to the exceptions and limitations specified in § 29.122-3 (a) except that no net operating loss deduction shall be taken into account; or

(2) In the case of a corporation, the normal-tax net income computed without regard to the exceptions, additions, and limitations specified in § 29.122-2 except that no net operating loss deduction shall be taken into account and the credit provided in section 26 (e) for income subject to the excess profits tax shall not be allowed.

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

Example. The aggregate of the net operating loss carry-overs and carry-backs to 1942 for the X Corporation is $55,000. Its net income for 1942, computed with the adjustments required by this section, is $450,000 and its normal-tax net income, computed without any exceptions, additions, and limitations, except that no net operating loss deduction is allowed and the credit provided in section 26 (e) for income subject to the excess profits tax is not allowed, is $445,000. The net operating loss deduction available to the X Corporation for the year 1942 is $50,000, computed as follows:

Aggregate of net operating loss carry-overs and carry-backs to 1942	$55,000
Less: Excess of net income for 1942, with adjustments, over normal-tax net income for 1942, without adjustments except that no net operating loss deduction shall be allowed and the credit provided in section 26 (e) for income subject to the excess profits tax shall not be allowed ($450,000 minus $445,000)	5,000
Net operating loss deduction for 1942	50,000

If the same facts are assumed for an individual, except that, instead of having a normal-tax net income for 1942 of $445,000, he has a net income in such year of $445,000, computed without adjustment except that no net operating loss deduction shall be allowed, his net operating loss deduction for 1942 will likewise be $50,000, computed in the same manner.

(c) In the case of a husband and wife making a joint return for any taxable year, the computation of the net operating loss deduction (as set forth in paragraph (a) of this section) is to be made upon the basis of the aggregate of the joint net operating loss carry-overs and joint net operating loss carry-backs of the spouses to such year (computed as prescribed in § 29.122-4 (e)) and the combined net income of the spouses.

§ 29.123-1 *Election to include loans in income.* A taxpayer who receives a loan from the Commodity Credit Corporation may, at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election, then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return.

§ 29.123-2 *Effect of election on adjustments for other taxable years.* If a taxpayer elects or has elected under section 123 of the Internal Revenue Code or section 223 (d) of the Revenue Act of 1939, as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation for the taxable year in which it is received, then:

(a) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the year in which received; and

(b) No deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

Example. A, a taxpayer who elected for his taxable years 1938, 1939, and 1940 to include in gross income amounts received during those years as loans from the Commodity Credit Corporation, received as loans $500 in 1938, $700 in 1939, and $900 in 1941. In 1942 all the pledge commodity was sold by the Commodity Credit Corporation for an amount $100 and $200 less than the loans with respect to the commodity pledged in 1938 and 1939, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1941. A, in making his return for 1942, shall include in gross income the sum of $150 if it is received during that year, but will not be allowed a deduction for the deficiencies of $100 and $200 unless he is required to satisfy such deficiencies and does satisfy them during that year.

§ 29.124-0 *Definitions.* As used in this section and § 29.124-1 to 29.124-9, the term:

(a) "Certifying officer" means the Secretary of the Army or the Secretary of the Navy, as the case may be, or the duly authorized representative of either. The term "certifying officer" includes the Chairman of the War Production Board,

or his duly authorized representative, in case any certification provided for in section 124 is made by the Chairman of the War Production Board or his duly authorized representative pursuant to Executive order.

(b) "Emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof:

(1) The acquisition of which occurred after December 31, 1939, or the construction, reconstruction, erection, or installation of which was completed after such date, and

(2) Any part of the construction, reconstruction, erection, installation, or acquisition of which has, under such regulations as may be prescribed by the Secretary of the Army and the Secretary of the Navy or the Chairman of the War Production Board or his duly authorized representative, with the approval of the President, been certified by the certifying officer as necessary in the interest of national defense during the emergency period.

(3) The part of any facility which is constructed, reconstructed, erected, or installed by any person after December 31, 1939, and not earlier than six months prior to the filing of an application for a certificate of necessity under section 124 (f), and which is certified by the certifying officer as necessary in the interest of national defense during the emergency period, shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. If the construction, reconstruction, erection, or installation of a facility by a corporation is begun before June 11, 1940, and completed after June 10, 1940, the part of such facility which which is constructed, reconstructed, erected, or installed after December 31, 1939, and before June 11, 1940, shall be deemed to be an emergency facility, provided such part is certified by the certifying officer as necessary in the interest of national defense during the emergency period.

(4) The term "emergency facility," as so defined, may include, among other things, improvements of land, such as the construction of airports and the dredging of channels.

(c) "Emergency period" means the period beginning on January 1, 1940, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities is no longer required in the interest of national defense.

CROSS REFERENCE: For proclamation of the end of the emergency period, defined in section 124 of the Internal Revenue Code, see 3 CFR, 1945 Supp., Proc. 2669.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124–1 *Certificate of necessity.* The certification by the certifying officer that a facility is necessary in the interest of national defense during the emergency period shall have no effect:

(a) In the case of an emergency facility completed or acquired by a corporation after June 10, 1940, unless an application therefor is filed before the expiration of six months after the beginning of the construction, reconstruction, erection, or installation of such facility or the date of its acquisition, or before December 1, 1941, whichever is later (but see § 29.124–0 (b));

(b) In the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, unless an application therefor is filed before April 22, 1943; and

(c) In the case of an emergency facility completed or acquired after December 31, 1939, by a person other than a corporation, unless an application therefor is filed before the expiration of six months after the beginning of the construction, reconstruction, erection, or installation of such facility or the date of its acquisition, or before April 22, 1943, whichever is later.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124–2 *Amortization deduction; general rule.* (a) If the certifying officer makes the required certification of necessity, a person is entitled, at its election, to a deduction with respect to the amortization of the adjusted basis of an emergency facility, such amortization to be based generally on a period of 60 months. As to the adjusted basis of an emergency facility, see § 29.124–6. The taxpayer may, with respect to an emergency facility, elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that

in which such facility was completed or acquired (see § 29.124-3). The date on which, or the month within which, an emergency facility is completed or acquired is a question to be determined upon the facts in the particular case. Ordinarily the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility. If the construction, reconstruction, erection, or installation of an emergency facility by a corporation is begun before June 11, 1940, and completed after June 10, 1940, the part of such emergency facility which is constructed, reconstructed, erected, or installed after December 31, 1939, and before June 11, 1940, shall be deemed to have been completed on June 10, 1940.

(b) With respect to an emergency facility, no amortization deduction shall be allowed for the taxable year in which or with which the taxpayer elects to begin the 60-month amortization period unless:

(1) In the case of an emergency facility completed or acquired by a corporation after June 10, 1940, a certificate of necessity in respect thereof shall have been made (i) before the filing of the taxpayer's return for such taxable year, or before the making of an election pursuant to section 124 (d) (3) or section 124 (d) (6) to take the amortization deduction, or (ii) before December 1, 1941, whichever is later;

(2) In the case of an emergency facility completed or acquired by a corporation after December 31, 1939, and before June 11, 1940, unless a certificate of necessity in respect thereof shall have been made before October 22, 1943;

(3) In the case of an emergency facility completed or acquired by a person other than a corporation after December 31, 1942, unless a certificate of necessity in respect thereof shall have been made before the filing of the taxpayer's return for such taxable year, or before the making of an election pursuant to section 124 (d) (3) or section 124 (d) (6); or

(4) In the case of an emergency facility completed or acquired after December 31, 1939, and before January 1, 1943, by a person other than a corporation, unless a certificate of necessity in respect thereof shall have been made (i) before the expiration of nine months after the last date upon which an application for such certificate may be filed or (ii) before October 22, 1943, whichever is later.

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis of the facility at the end of any month shall be computed without regard to the amortization deduction with respect to such facility for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable with respect to such facility for each month of the 60-month period which falls within such taxable year. The amortization deduction with respect to an emergency facility taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 23 (l) with respect to such facility for such month. See, however § 29.124-7, relative to depreciation with respect to any amount not subject to amortization.

(d) This section may be illustrated by the following examples:

Example (1). On July 1, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1942, at a cost of $240,000. The certificate of necessity covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with respect to such facility for the taxable year 1942 is $12,000, computed as follows:

Monthly amortization deductions:	
October ($240,000÷60)	$4,000
November ($236,000, or $240,000 minus $4,000÷59)	4,000
December ($232,000, or $236,000 minus $4,000÷58)	4,000
Total amortization deduction for 1942	12,000

Example (2). The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1943. On June 15, 1943, it begins the construction of an emergency facility (No. 2), which is completed on August 2, 1943. The entire acquisition and construction of such facilities are certified as necessary in the interest of national defense. The Y Corporation elects to take amortization deduction with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. The adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000 at the end of the first month of the amortization period. In September 1943 facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1943, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:		
August ($300,000÷60)	$5,000	
September ($269,630, or $300,000 minus $5,000 and $25,370÷59)	4,570	
October ($265,060, or $269,630 minus $4,570, ÷58)	4,570	
November ($260,480, or $265,060 minus $4,570 ÷57)	4,570	
Amortization deduction for 1943		$18,710

Facility No. 2

Monthly amortization deductions:		
September ($54,000÷60)	$900	
October ($53,100÷59)	900	
November ($52,200÷58)	900	
Amortization deduction for 1943		2,700
Total amortization deduction for 1943		21,410

Example (3). On June 15, 1941, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1941, filed on March 15, 1942, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July, the month following its completion. No certificate of necessity with respect to such facility is made until April 10, 1942, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1941. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1941, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1942 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1942 the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000, computed as follows:

Monthly amortization deductions:	
January ($108,000÷54)	$2,000
February ($106,000, or $108,000 minus $2,000, ÷ 53)	2,000
March ($104,000, or $106,000 minus $2,000, ÷ 52)	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization for 1942	24,000

Since the Z Corporation elected in its return for 1941 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1941, it must compute its amortization deductions for the 12 months in the taxable year 1942 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

Example (4). On March 18, 1940, the R Corporation, which makes its income tax returns on the calendar year basis, begins the construction of a facility which is completed on October 25, 1940, at a cost of $350,000, of which $132,000 is attributable to construction before June 11, 1940, and $218,000 to construction after June 10, 1940. On January 28, 1941, the entire part of the construction after June 10, 1940, is certified as an emergency facility, and the R Corporation, in its income tax return for 1940, elects to take amortization deductions with respect thereto and to begin the 60-month amortization period with November 1940, the month following the month of completion. With respect to the part of the construction before June 11, 1940, the R Corporation in its returns for 1940 and 1941, takes depreciation deductions aggregating $5,000. On February 14, 1943, the entire part of the construction before June 11, 1940, is certified as a separate emergency facility. The R Corporation, in a statement in writing to the Commissioner made before April 22, 1943, elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1940, the month following the month of completion. For such purposes, the adjusted basis of such facility at the end of July 1940 is $132,000. Since amortization deductions are in lieu of depreciation deductions, the depreciation deductions of $5,000 previously taken for 1940 and 1941 are disallowed. The allowable amortization deduction with respect to such facility for the taxable year 1940 is $13,200, computed as follows:

Monthly amortization deductions:

July ($132,000÷60)	$2,200
August ($129,800÷59)	2,200
September ($127,600÷58)	2,200
For the remaining three months (similarly computed)	6,600
Total amortization deduction for 1940	13,200

The allowable amortization deduction with respect to such facility for the taxable year 1941, similarly computed, is $26,400.

Example (5). On April 1, 1940, A, an individual, who makes his income tax returns on a calendar year basis, acquires a facility at a cost of $182,700. In his returns for the taxable years 1940 and 1941, A takes depreciation deductions with respect to such facility of $2,700 and $3,600, respectively. On February 6, 1943, the facility is certified as an emergency facility and A, in a statement in writing made to the Commissioner before April 22, 1943, elects to take amortization deductions with respect thereto and to begin the 60-month amortization period with the taxable year 1941, the year succeeding the year in which the facility was acquired. The adjusted basis of such facility at the end of January 1941 is $180,000 ($182,700 less the depreciation of $2,700 taken in the return for 1940). Since amortization deductions are in lieu of depreciation deductions, the depreciation deduction of $3,600 previously taken for 1941 is disallowed. The allowable amortization deduction with respect to such facility for the taxable year 1941 is $36,000, computed as follows:

Monthly amortization deductions:

January ($180,000÷60)	$3,000
February ($177,000÷59)	3,000
March ($174,000÷58)	3,000
For the remaining nine months (similar computed)	27,000
Total amortization deductions for 1941	36,000

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124-3 *Election of amortization.* (a) In the case of an emergency facility completed or acquired after June 10, 1940, by a corporation or after December 31, 1941, by a person other than a corporation:

(1) An election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period with the month following the month in which such facility was completed or acquired shall be made only by a statement to that effect in its return for the taxable year in which such facility was completed or acquired; and

(2) An election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period with the taxable year succeeding that in which such facility was completed or acquired shall be made only by a statement to that effect in its return for such succeeding taxable year.

(b) In the case of an emergency facility completed or acquired (1) after December 31, 1939, and before June 11, 1940, by a corporation, or (2) after December 31, 1939, and before January 1, 1942, by a person other than a corporation, an election by the taxpayer to take amortization deductions with respect thereto and to begin the 60-month amortization period either with the month following the month of completion or acquisition or with the following taxable year shall be made only by a statement in writing to that effect filed with the Commissioner of Internal Revenue, Washington, D. C., before April 22, 1943.

(c) No other method of making such elections is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed.

(d) A taxpayer which does not elect, in the manner provided in section 124 (b), to take amortization deductions with respect to an emergency facility shall not, except as provided in sections 124 (d) (3) and 124 (d) (6), be entitled to amortization deductions with respect to such facility (see § 29.124-5 (d)).

§ 29.124-4 *Election to discontinue amortization.* (a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions with respect to such facility for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing field with the Commissioner specifying the month as of the beginning of which the taxpayer elects to discontinue the deductions. Such notice shall be filed before the beginning of the month specified therein, and should contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions with respect to an emergency facility, it shall not, except as provided in section 124 (d), be en-

titled to any further amortization deductions with respect to such facility (see § 29.124-5 (c)).

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 23 (1) and the regulations pertaining thereto, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 113 (b) and the regulations thereunder).

(c) This section may be illustrated by the following example:

Example. On July 1, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000, of which $60,000 is allocable to the land and $246,000 to the building. The certificate of necessity covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with the taxable year 1943. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1942. On March 25, 1944, the corporation files notice with the Commissioner of its election to discontinue the amortization deductions beginning with the month of April 1944. The adjusted basis of the facility on January 31, 1943, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1942 ($6,000). The amortization deduction for the taxable year 1943 and the months of January, February, and March, 1944, amounts to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1943), the adjusted basis of the land is one-fifth of the adjusted basis of the entire facility and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1944, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 23 (l), and $45,000 is allocable to the land.

§ 29.124-5 *Termination of amortization period*—(a) *Date the emergency use ceases.* As used in this section, the term "date the emergency use ceases" means whichever of the following is the earlier:

(1) The date of the proclamation by the President by reason of which the emergency period ends; or

(2) The date specified in a certificate with respect to an emergency facility made to the Commissioner by the certifying officer (in accordance with regulations prescribed by the President) as the date on which such facility ceased to be necessary in the interest of national defense during the emergency period.

(b) *Taxpayer which has elected to amortize.* A taxpayer which has elected to take amortization deductions with respect to an emergency facility may elect, in the manner provided in paragraph (e) of this section, to terminate the amortization period with respect to such facility as of the end of the month in which occurs the date the emergency use ceases, provided that such date occurs prior to the expiration of the original 60-month period. In such case there shall, with respect to such facility, be substituted, in lieu of the original 60-month period, a new amortization period beginning with the first month of the original 60-month period and ending with the end of the month in which occurs the date the emergency use ceases; and the taxpayer's taxes for all taxable years (beginning with the taxable year in which the original 60-month period began) shall be computed (or recomputed) so as to give effect to amortization deductions with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of the new amortization period.

Example. On August 15, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility for the purpose of performing War Department contracts. The corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with September, 1942, the month following the month of acquisition. The certifying officer certifies to the Commissioner that such facility ceases, as of July 15, 1944, to be necessary in the interest of national defense. The X Corporation elects to terminate the amortization period and, accordingly, there is to be substituted, in lieu of the 60-month amortization period, a new amortization period of 23 months (4 months in 1942, 12 months in 1943, and 7 months in 1944). The X Corporation's taxes for the taxable years 1942, 1943, and 1944 shall be computed or recomputed so as to give effect to amortiza-

tion deductions computed in the manner provided in section 124 (a) but on the basis of the new 23-month amortization period.

(c) *Taxpayer which has elected to discontinue amortization.* A taxpayer which has elected to take amortization deductions with respect to an emergency facility and has subsequently elected under section 124 (c) (see § 29.124-4) to discontinue, as of the beginning of a specified month, the amortization deductions with respect to such facility may elect, in the manner provided in paragraph (e) of this section, to terminate the amortization period with respect to such facility as of the end of the month in which occurs the date the emergency use ceases: *Provided,* That such date occurs prior to the expiration of the original 60-month period and after the beginning of such specified month. In such case, with respect to such facility, the election to discontinue the amortization deductions shall be disregarded and there shall be substituted, in lieu of the original 60-month period, a new amortization period beginning with the first month of the original 60-month period and ending with the end of the month in which occurs the date the emergency use ceases. The taxpayer's taxes for all taxable years (beginning with the taxable year in which the original 60-month period began) shall be computed (or recomputed) so as to give effect to amortization deductions with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of the new amortization period.

Example. On November 1, 1942, the Y Corporation, which makes its income tax returns on the basis of a fiscal year ending June 30, begins the construction of an emergency facility which is completed on March 15, 1943. The corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with April 1943, the month following the completion. On January 15, 1944, the corporation files a notice with the Commissioner in which it elects to discontinue the amortization deductions with respect to such facility as of the beginning of February 1944. The President issues a proclamation on August 16, 1944, by reason of which the emergency period ends. The Y Corporation then elects to terminate the amortization period and, accordingly, its election to discontinue the amortization deductions is to be disregarded. In such case, there is to be substituted, in lieu of the original 60-month amortization period, a new amortization period of 17 months (3 months in the taxable year ending June 30, 1943, 12 months in the taxable year ending June 30, 1944, and 2 months in the taxable year ending June 30, 1945). The corporation's taxes for the taxable years ending June 30, 1943, 1944, and 1945, are to be computed or recomputed so as to give effect to amortization deductions (in lieu of amortization and depreciation deductions previously taken during such 17-month period) computed in the manner provided in section 124 (a) but on the basis of the new 17-month amortization period.

If the date the emergency use ceases should occur between the date of the notice of discontinuance and the beginning of the month specified in such notice, the provisions of section 124 (d) (1) and paragraph (b) of this section are applicable.

(d) *Taxpayer which has not elected to amortize*—(1) *General rule.* A taxpayer which has obtained the required certifications but has not elected, as provided in section 124 (b), to take amortization deductions with respect to the emergency facility to which such certifications relate may nevertheless take amortization deductions with respect to such facility, if (i) the date the emergency use ceases occurs before the expiration of 60 months from the last day of the month in which such facility was completed or acquired, and (ii) an election to take such amortization deductions is made in the manner prescribed in paragraph (e) of this section. In such case, the taxes for all taxable years (beginning with the taxable year in which fell the month following the month in which such facility was completed or acquired) shall be computed (or recomputed) so as to give effect to amortization deductions with respect to such facility computed in the manner provided in section 124 (a) (see § 29.124-2) but on the basis of an amortization period beginning with the month following the month in which such facility was completed or acquired, and ending with the last day of the month in which occurs the date of the emergency use ceases.

Example. On September 25, 1942, the Z Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility for the purpose of performing Navy Department contracts. The corporation does not elect to take amortization deductions with respect to such facility. The certifying officer certifies to the Commissioner that such facility ceased, as of July 20, 1944, to be necessary in the interest of national defense. The Z Corporation may elect, in the manner provided in paragraph (e) of this section, to take amortization de-

ductions with respect to such facility and in such case its taxes for the taxable years 1942, 1943, and 1944 are to be computed or recomputed so as to give effect to amortization deductions computed in the manner provided in section 124 (a) but on the basis of an amortization period of 22 months (3 months in 1942, 12 months in 1943, and 7 months in 1944), such amortization deductions to be in lieu of depreciation deductions previously taken during such 22-month period.

(2) *Special rule with respect to incompleted facilities.* If the date the emergency use ceases occurs after the beginning of the construction, reconstruction, erection, or installation of an emergency facility and such construction, reconstruction, erection, or installation is not completed, the taxpayer may elect, in the manner prescribed in paragraph (e) of this section, to take amortization deductions with respect to such facility, such amortization to be based on a period beginning with the month in which the construction, reconstruction, erection, or installation of such facility was begun and ending as of the end of the month in which occurs the date the emergency use ceases.

(e) *Manner of making election.* The election described in paragraph (b), (c), or (d) of this section shall be made by filing with the Commissioner of Internal Revenue, Washington, D. C., a statement of such election. Such statement shall be filed within 90 days after the date of the President's proclamation or the date of the certificate of the Secretary of the department concerned, whichever is the basis of the taxpayer's election, and should contain a description clearly identifying the facility. A copy of such statement should be attached by the taxpayer to the income-tax return for the taxable year in which falls the date the emergency use ceases.

(f) *Recomputation of taxes in case of commuted amortization period.* (1) The recomputation of the tax liability authorized by section 124 (d) (4) applies to any income or excess-profits tax imposed under chapter 1 or subchapter A, B, D, or E of chapter 2, to the capital stock tax imposed by chapter 6, and to any other tax of the corporation affected directly or indirectly by the recomputation of the amortization deduction.

(2) Under section 124 (d) (5), if the adjustment of any income or excess-profits tax for any taxable year to give effect to the revised amortization deduction is prevented (i) on the date of the certificate of the Secretary of the department concerned or the date of the President's proclamation, whichever forms the basis of the taxpayer's election, or (ii) within one year after such date, by any provision of law (other than section 3761, relating to compromises, and other than section 124 (d) (5)) or by any rule of law, including the doctrine of res judicata, an adjustment shall nevertheless be made if a claim for refund or credit is filed or a notice of deficiency is mailed, as the case may be, within one year after the date of such certificate or proclamation. Section 124 (d) (5) applies only if, at the time of the filing of the claim for refund or the mailing of the notice of deficiency, the adjustment would otherwise be prevented by the running of the statute of limitations, by the execution of a closing agreement, by the operation of the rule of res judicata, or for other reasons. For reference to provisions which would prevent adjustment except for the provisions of section 124 (d) (5), see § 29.3801 (b)-0. Section 124 (d) (5) is not applicable, however, if on the date of the filing of the claim for refund or the mailing of the notice of deficiency, adjustment of the tax liability is permissible without recourse to such section.

(3) The amount of the adjustment authorized by section 124 (d) (5) is limited to the increase or decrease in the tax previously determined for the taxable year which results solely from the revision of the amortization deduction and the collateral effects of such revision upon items of income, deductions, credits, invested capital, etc., already taken into account in ascertaining the tax previously determined. The tax previously determined for any taxable year is to be ascertained in accordance with the provisions of section 3801 (d). See § 29.3801 (d)-1. If the amount of the adjustment determined under section 124 (d) (5) represents an increase in tax, it is to be treated in the same manner as a deficiency for the taxable year; if it represents a decrease in tax, it is to be treated in the same manner as an overpayment for the taxable year. The amount of the adjustment considered as a deficiency or as an overpayment, as the case may be, will bear interest to the extent provided by the internal revenue laws applicable to deficiencies and over-

payments for the taxable year for which the adjustment is made.

(4) The amount of any adjustment under the provisions of section 124 (d) (5) which is refunded may not subsequently be recovered in a suit for erroneous refund based upon any adjustment other than one resulting from the revision of the amortization deductions. The amount of any adjustment under section 124 (d) (5) which is assessed and collected as a deficiency may not thereafter be recovered by the taxpayer in any suit for refund based upon any adjustment other than one resulting from the revision of the amortization deductions. The application of the provisions of section 124 (d) (5) may be illustrated by the following example:

Example. On August 31, 1942, the X Corporation, which makes its income tax returns on the calendar year basis, acquires an emergency facility at a cost of $300,000 and elects to take amortization deductions with respect to such facility over the 60-month period beginning with the month of September 1942. For the taxable year 1942 the corporation files an income tax return disclosing a net income of $73,800, corporation surtax net income of $65,300, and normal tax net income of $65,300. The return discloses a tax liability of $19,993, which is assessed and paid. In making such computation, the corporation takes amortization deductions of $5,000 a month for four months, or $20,000, but in computing its gross income erroneously omits interest income amounting to $6,000, and in computing its deductions erroneously omits a deduction for insurance expense of $2,000. The corporation includes in gross income dividends from a domestic corporation in the amount of $10,000 and takes a dividends received credit of $8,500. It also files an excess-profits tax return under subchapter E of chapter 2 disclosing an invested capital of $637,500, an excess-profits net income of $68,000, an excess-profits credit of $51,000 computed on the invested capital basis, and an excess-profits tax liability of $4,200.

On September 1, 1946, the Secretary of the department concerned certifies to the Commissioner that such emergency facility ceased as of August 15, 1946, to be necessary in the interest of national defense. The X Corporation elects to terminate the amortization period and to amortize the adjusted basis of such facility over the shortened period of 48 months beginning September 1, 1942, and ending August 31, 1946. The corporation is therefore entitled to compute or recompute its taxes for 1942, 1943, 1944, 1945, and 1946 on the basis of an amortization deduction of $6,250 in lieu of $5,000 for each month beginning with September 1942 and ending with August 1946. The allowable deduction for 1942 is therefore $25,000 in lieu of $20,000. Claims for refund for all years, except 1946, are filed on November 30, 1946. For the taxable year 1942 the period of limitations upon the filing of a claim for refund provided by section 322 expires on March 15, 1946. Since, however, the claim is filed within one year from the date of the certificate of the Secretary of the department concerned, an adjustment is authorized under section 124 (d) (5). The amount of the adjustment of the income taxes under sections 13 and 15 and the excess-profits tax under subchapter E of chapter 2 for 1942 is $2,758 (income taxes, $1,008; excess-profits tax, $1,750), computed as follows:

EXCESS-PROFITS TAX

Excess-profits net income reported		$68,000.00
Less: Additional deduction for amortization		5,000.00
Excess-profits net income as recomputed		63,000.00
Less:		
Exess-profits credit	$51,000.00	
Specific exemption	5,000.00	
		56,000.00
Adjusted excess-profits net income		7,000.00
Exess-profits tax as recomputed		2,450.00
Tax previously determined and paid		4,200.00
Amount of adjustment under section 124 (d) (5) to be refunded or credited		1,750.00

INCOME TAX

Net income upon which tax previously determined was based		$73,800.00
Less: Additional deduction for amortization:		
Amount deductible	$25,000.00	
Amount deducted in return	20,000.00	
		5,000.00
Balance		68,800.00
Add: Adjustment for excess-profits tax:		
Amount previously deducted	$4,200.00	
As recomputed	2,450.00	
		1,750.00
Net income as recomputed		70,550.00
Less: Dividends received credit		8,500.00
Corporation surtax net income		62,050.00
Less: Interest on obligations of the United States and its instrumentalities		None

Normal tax net income		$62,050.00
Surtax on $25,000	$1,500.00	
Surtax on $37,050	2,593.50	
Normal tax on $62,050	14,892.00	
Income tax as recomputed		18,985.50
Income tax previously determined		19,993.00
Amount of adjustment under section 124 (d) (5) to be refunded or credited		1,007.50

By reason of the limitations imposed by section 124 (d) (5), the adjustment is limited to the decrease in the tax previously determined which results solely from the revision of the amortization deductions and the consequences flowing therefrom. Accordingly, the recomputation does not take into consideration the item of $6,000, representing interest received, which was omitted from gross income, or the item of $2,000, representing insurance expense, for which no deduction was allowed.

Since the claims for refund for the taxable years 1943, 1944, and 1945 were filed within the period of limitations provided in section 322, the provisions of section 124 (d) (5) are not applicable and the complete adjustment of the taxes for such taxable years may be made without regard to the limitations contained in section 124 (d) (5).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124-6 *Adjusted basis of emergency facility*—(a) *In general.* (1) The adjusted basis of an emergency facility for purposes of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility, in that it shall be the adjusted basis for determining gain (see section 113) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to the certified construction, reconstruction, erection, installation, or acquisition after December 31, 1939. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes, in cases where the entire construction, reconstruction, erections, installation, or acquisition takes place after December 31, 1939, and such construction, reconstruction, erection, installation, or acquisition is certified in its entirety by the certifying officer as necessary in the interest of national defense during the emergency period, is the same as the unadjusted basis otherwise determined.

(3) In cases where the certifying officer certifies the entire construction, reconstruction, erection, installation, or acquisition after December 31, 1939, as necessary in the interest of national defense during the emergency period, but only a portion of the construction, reconstruction, erection, installation, or acquisition attributable to the facility takes place after December 31, 1939, the unadjusted basis for the purposes of amortization is so much of the entire unadjusted basis as is attributable to that portion of the construction, reconstruction, erection, installation, or acquisition which took place after December 31, 1939. For example, the X Corporation begins the construction of a facility November 15, 1939, and such facility is completed on April 1, 1940, at a cost of $500,000, of which $300,000 is attributable to construction after December 31, 1939. The certificate of necessity covers the entire construction after December 31, 1939, and the unadjusted basis of the emergency facility for amortization purposes is therefore $300,000. For depreciation of the remaining portion of the cost ($200,000) see § 29.124-7.

(4) If the certifying officer certifies only a portion of the construction, reconstruction, erection installation, or acquisition after December 31, 1939, then the unadjusted basis for amortization purposes is limited to the amount attributable to such portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1939. Assuming the same facts as in the example in the preceding paragraph, except that the certificate is to the effect that only 50 percent of the construction after December 31, 1939, is necessary in the interest of national defense during the emergency period, the unadjusted basis for amortization purposes is 50 percent of $300,000, or $150,000.

(5) Where a corporation begins the construction, reconstruction, erection, or installation of a facility before June 11, 1940, and completes it after June 10, 1940, the part of such construction, reconstruction, erection, or installation taking place after December 31, 1939, and before June 11, 1940, and the part thereof taking place after June 10, 1940, each constitutes a separate emergency

facility, provided a certificate of necessity under section 124 (f) has been made with respect to each such part (see section 124 (e) and § 29.124-0). Furthermore, the part of such construction, reconstruction, erection, or installation taking place after December 31, 1939, and before June 11, 1940, is deemed to have been completed on June 10, 1940 (see section 124 (e) (1) and § 29.124-2). Accordingly, under such circumstances, in applying the foregoing rules for determining the unadjusted basis of the emergency facility representing the part of the construction, reconstruction, erection, or installation taking place after June 10, 1940, the date "June 10, 1940" should be substituted for the date "December 31, 1939."

(6) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in section 113 (b), except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of this section.) Amounts received by a taxpayer in connection with its agreement to supply articles for national defense, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility. The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example (1). The X Corporation completes an emergency facility on July 1, 1940, the entire unadjusted basis of which is $500,000 and the unadjusted basis of which for puposes of amortization is $300,000. The X Corporation elects to begin amortization on January 1, 1941. The only adjustment to basis for the period from July 1, 1940, to January 31, 1941, other than depreciation or amortization for January 1941, is $5,000 for depreciation for the last six months of 1940. The adjusted basis for purposes of amortization is therefore $300,000 less $3,000 (300,000/500,000ths of $5,000), or $297,000.

Example (2). On July 31, 1944, the Y Corporation has an emergency facility (a building) completed on July 1, 1940, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for purposes of amortization is $300,000. The corporation elects to begin amortization on January 1, 1941, by which time it is entitled to $5,000 depreciation for the last six months of 1940. On July 1, 1944, the facility is damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted bases of the emergency facility as of July 1944 for purposes of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to January 1, 1941	3,000.00	2,000.00	5,000
Adjusted basis Jauuary 1941	297,000.00	198,000.00	495,000
Less amortization for 42 mouths	207,900.00	None	207,900
Less depreciation for 42 months	None	14,000.00	14,000
Adjusted basis at time of fire loss	89,100.00	184.000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for purposes of amortization and the adjusted basis for purposes of depreciation in the proportion that each such adjusted basis at the time of such fire loss bears to their sum, i. e., 89,100/273,100ths of $200,000 or $65,250.82, against the amortization basis, and 184,000/273,100ths of $200,000 or $134,749.18, against the depreciation basis.

(b) *Capital additions.* If, after the completion or acquisition of an emergency facility with respect to which a certificate of necessity has been made, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not included in such certificate of necessity, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certificate. If such further expenditures are covered by a separate certificate of necessity made in accordance with the provisions of section 124 (f), they are treated as certified expenditures in connection with a new emergency facility, and, if proper

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election is made, will be taken into account in computing the adjusted basis of such new emergency facility for purposes of amortization.

Example. On March 1, 1942, the Secretary of the department concerned certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1942. The Z Corporation, on August 1, 1942, begins the installation in the plant of an additional boiler, which is not included in the certificate for the plant but is, prior to such installation, certified in a separate certificate as necessary in the interest of national defense. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124-7 *Depreciation of portion of emergency facility not subject to amortization.* (a) The rule set forth in section 124 (a) (see § 29.124-2), that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable with respect to such facility, is subject to the exception provided in section 124 (g). Under this exception, if the property constituting such facility is depreciable property under section 23 (l) and the regulations pertaining thereto and if the adjusted basis of such facility as computed under section 113 (b) for purposes other than the amortization deductions (see § 29.113 (b) (1-1) is in excess of the adjusted basis computed under section 124 (f) for purposes of the amortization deductions (see § 29.124-6), then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1939, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see § 29.124-6). However, if the property constituting such facility is depreciable property under section 23 (l) and the regulations pertaining thereto, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1939.

(b) Similarly, if only a part of the construction, reconstruction, erection, installation, or acquisition after December 31, 1939, of an emergency facility has been certified by the certifying officer as necessary in the interest of national defense during the emergency period, and if such facility is depreciable property under section 23 (l) and the regulations pertaining thereto, then the depreciation deduction provided by such section and regulations is allowable with respect to the part which has not been so certified.

(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in § 29.124-6 (a).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5432, 10 F. R. 919]

§ 29.124-8 *Payment by United States of unamortized cost of facility.* (a) Section 124 (h) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If the amount of any such payment is properly includible in gross income and has been certified, as provided in section 124 (h), as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take such amount as an amortization deduction with respect to such facility for the month in which such amount is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, and shall not in any case exceed the adjusted basis of such facility (see § 29.124-6), as of the end of such month (computed without regard to any amortization deduction for such month). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 23 (l) for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total

deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 124 (f) and § 29.124-6 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 23 (l) or 124 (h) (2)). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example (1). On January 31, 1942, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate of necessity covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1942, the month following the month of acquisition. On July 15, 1943, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1943. The adjusted basis of such facility for amortization purposes as of the end of July 1943, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example (2). On November 30, 1942, the Y Corporation purchases an emergency facility, consisting of land with a building thereon at a cost of $500,000 of which $200,000 is allocable to the land and $300,000 to the building. The certificate of necessity covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1944, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unamortized cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1944. The adjusted basis of the facility as of the end of August 1944, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1944 by the full amount of the $400,000 payment.

§ 29.124-9 *Life tenant and remainderman.* In the case of an emergency facility held by one person for life with remainder to another person, the amortization deduction shall be computed as if the life tenant were the absolute owner of the facility and shall be allowable to the life tenant during his life.

§ 29.124-10 *Application for tentative adjustments*—(a) *In general.* (1) Any taxpayer who has filed with the Commissioner a statement of election to terminate the amortization period, as prescribed in section 124 (d) (4), may file an application for a tentative adjustment with respect to the taxes for all taxable years prior to the taxable year in which the application is filed, but not including any taxable year prior to the taxable year in which the amortization period began, which are affected by the revision of the amortization deduction or any related adjustments. A taxpayer who is a member of a partnership which has filed a statement of election to terminate the amortization period may file an application for a tentative adjustment with respect to his own taxes which results from the increase or decrease in his distributive share of the partnership net income attributable to the revision of the amortization deduction or any related adjustments. The adjustment with respect to such taxes is to be computed as required by section 124 (d) (4). The tax for each taxable year which is to be recomputed, however, shall be the tax previously determined as ascertained in accordance with the method prescribed in section 3801 (d). The amount of the adjustment with respect to each tax is limited to the increase or decrease in such tax as previously determined which results from the revision of the amortization deduction and the effect of such revised deduction upon any items taken into account in computing the tax previously determined.

(2) The application for a tentative adjustment must be filed within 90 days from the date the statement of election provided in section 124 (d) (4) is filed. If, however, such 90-day period expired before October 29, 1945, the application is timely if it was filed on or before October 29, 1945. The application is to be filed with the collector where the tax was paid or the assessment was made.

(b) *Contents of application.* (1) The application for a tentative adjustment

with respect to amortization deductions in the case of a corporation is to be filed on Form 1140, and in the case of taxpayers other than corporations on Form 1046. The applications are to be filled out in accordance with the instructions accompanying such forms, and all information required by the forms and the accompanying instructions must be furnished by the taxpayer. The application in the case of a corporation is to be sworn to in the manner provided in section 52 in the case of a corporation income tax return. The application in the case of a taxpayer other than a corporation is to be verified in the manner provided in sections 51 and 142 in the case of an income tax return of such taxpayer.

(2) An application for a tentative adjustment with respect to amortization deductions does not constitute a claim for credit or refund. If such application is disallowed by the Commissioner in whole or in part, no suit may be maintained in any court for the recovery of any tax based on such application. The taxpayer, however, may file a regular claim for credit or refund under section 124 (d) (5) or under section 322 at any time prior to the expiration of the applicable period of limitation, and may maintain suit based on such claim if it is disallowed or if the Commissioner does not act on the claim within six months from the date it is filed. Such regular claim may be filed before, simultaneously with, or after the filing of the application for a tentative adjustment with respect to amortization deductions. The filing of an application for a tentative adjustment will not constitute the filing of a claim for credit or refund within the meaning of section 124 (d) (5) or 322 (b) for purposes of determining whether a claim for credit or refund was filed prior to the expiration of the applicable period of limitation. The filing of such an application, however, will constitute the filing of a claim for credit or refund within the meaning of section 124 (d) (5) for purposes of determining whether an adjustment may be made in any case in which such adjustment is prevented by the operation of any provision of law other than section 124 (d) (5) itself or section 3761, relating to compromises. A regular claim for credit or refund filed under section 124 (d) (5) or section 322 after the filing of an application for a tentative adjustment with respect to amortization deductions is not to be considered an amendment of such application, but is to be considered a new claim. Such regular claim, however, in proper cases may constitute an amendment to a prior regular claim.

(c) *Computation of increase or decrease in taxes affected by the revised amortization deduction* (1) The taxpayer is to determine the amount of increase or decrease, attributable to the revised amortization deduction or any related adjustments, in each tax previously determined, which is affected by such revised amortization deduction or related adjustments, for each taxable year prior to the taxable year in which the application for a tentative adjustment is filed. The tax previously determined is to be ascertained in accordance with the method prescribed in section 3801 (d). In general, therefore, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies prior to the date of filing the application for a tentative adjustment with respect to amortization deductions, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Commissioner and the taxpayer are in disagreement at the time of the filing of the application shall be taken into account in ascertaining the tax previously determined only, and to the extent that, they were reported in the return, or were reflected in any amount assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, prior to the date of filing the application. The tax previously determined will reflect the foreign tax credit, the credit for tax withheld at source provided in section 32, the credit for debt retirement provided in section 783, and the 10-percent credit against excess profits tax provided in section 784, but will not reflect the postwar credit provided in section 780. In the case of any taxable year beginning in 1944 for which the credit provided in section 784 is not claimed on the return, the tax shown on the return, for purposes of this paragraph, shall be the tax shown on the return as filed reduced by the excess of (i) the credit under section 784 to the extent that an amount has not been abated, credited, refunded, or otherwise repaid in respect of such credit prior to the date of filing the application, over (ii) any amount claimed on the return as a credit for

debt retirement under section 783. In the case of any taxable year beginning prior to January 1, 1944, any amount abated, credited, refunded, or otherwise repaid prior to the date of filing the application, in connection with the post-war credit provided in section 780, and the amount of any bonds issued as provided in sections 780 and 781 in connection with the excess profits tax for such taxable year, whether or not such bonds have been redeemed, shall be considered an amount abated, credited, refunded, or otherwise repaid, in respect of the excess profits tax for such taxable year, prior to the date of filing the application.

(2) The increase or decrease in each tax previously determined which is affected by the revision of the amortization deduction or any related adjustments is to be determined, except for such revised amortization deduction and related adjustments, on the basis of the items which entered into the computation of such tax as previously determined; the tax previously determined being ascertained in the manner described in this paragraph. In determining any such increase or decrease, accordingly, items shall be taken into account only to the extent that they were reported in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, prior to the date of filing the application for a tentative adjustment with respect to amortization deductions. If the Commissioner and the taxpayer are in disagreement as to the proper treatment of any item, it shall be considered for purposes of determining the increase or decrease in the tax previously determined that such item was correctly reported by the taxpayer unless, and to the extent that, the disagreement has resulted in the assessment of a deficiency (or the collection of an amount without assessment), or the allowing or making of an abatement, credit, refund, or other repayment, prior to the date of filing the application. Thus, if the taxpayer claimed a deduction on its return of $50,000 for salaries paid its officers but the Commissioner asserts that such deduction should not exceed $20,000, and the Commissioner and the taxpayer have not agreed on the amount properly deductible prior to the date the application for a tentative adjustment with respect to amortization deductions is filed, $50,000 shall be considered as the amount properly deductible for purposes of determining the increase or decrease in each tax previously determined in respect of the application for a tentative adjustment. In determining the increase or decrease in any tax previously determined, any items which are affected by the revision of the amortization deduction must be adjusted to reflect such revised deduction. Thus, any deduction limited, for example, by net income or adjusted gross income, such as the deduction for charitable contributions, is to be recomputed on the basis of the net income or adjusted gross income as affected by the revision of the amortization deduction. Similarly, any deduction for depreciation which is affected by the revision of the amortization deduction must be adjusted to reflect such revised amortization deduction. No increase or decrease in tax, attributable to a net operating loss carry-back or to an unused excess profits credit carry-back, for a taxable year prior to the taxable year in which the amortization period began, may be assessed or allowed pursuant to an application for a tentative adjustment with respect to the amortization deduction even though the net operating loss or the unused excess profits credit resulting in such carry-back is affected by the revised amortization deduction. In determining the decrease in excess profits tax for any taxable year beginning prior to January 1, 1944, the tax as recomputed by taking into account the revised amortization deduction and any related adjustments is to be decreased by any amount which has been abated, credited, refunded, or otherwise repaid, prior to the date of filing the application, in connection with the post-war credit under section 780, and by the amount of any bonds, whether or not such bonds have been redeemed, issued as provided in sections 780 and 781 in connection with the excess profits tax for such taxable year, to the extent that such amounts are properly allocable to such tax as recomputed.

(3) In determining the increase or decrease in any tax previously determined which is affected by the revision of the amortization deduction or any related adjustments, the tax previously determined is to be increased or decreased by the amount of any increase or decrease in such tax shown on an application filed under section 3780, relating to tentative carry-back adjustments, to the extent that such increase or de-

crease shown in the application filed under section 3780 has not been assessed or allowed prior to the date of filing the application for a tentative adjustment with respect to amortization deductions. The items which enter into the computation of the tax previously determined are to be adjusted in conformity with such increase or decrease shown in the application filed under section 3780 for a tentative carry-back adjustment. The provisions of this paragraph are not to apply in any case in which the Commissioner has disallowed the application for a tentative carry-back adjustment prior to the date the application for a tentative adjustment with respect to amortization deductions is filed.

(d) *Allowance of adjustments.* (1) Any application for a tentative adjustment with respect to the amortization deduction is to be acted upon within a period of 90 days from the date such application is filed. The Commissioner is to make, to the extent he deems practicable in such 90-day period, an examination of the application to discover omissions and errors of computation and is to determine within such 90-day period the increase or decrease in any tax previously determined, which is affected by the revision of the amortization deduction or any related adjustments, upon the basis of the application and such examination. Such increases and decreases are to be determined in the same manner as that provided in section 124 (j) for the determination by the taxpayer of the increases and decreases in taxes previously determined which must be set forth in the application for a tentative adjustment with respect to the amortization deduction. The Commissioner, however, may correct any errors of computation or omissions he discovers upon whatever examination of the application he makes. In determining the increase or decrease in each tax previously determined which is affected by the revision of the amortization deduction or any related adjustments, the Commissioner accordingly may correct any mathematical error appearing on the application and he likewise may make any other adjustments to, or corrections in, the computations of the taxpayer which he deems are proper and which fall within the scope of the prescribed basis of the computation. If a required adjustment has not been made by the taxpayer and the Commissioner has available the necessary information to make such adjustment within the above 90-day period, he may, in his discretion, make such adjustment. In determining the increases and decreases, however, the Commissioner will not, for example, change the amount claimed in the return as a deduction for ordinary and necessary business expenses because he believes that the taxpayer has claimed an excessive amount; likewise, the Commissioner will not include in gross income any amount not so included by the taxpayer even though he believes that such amount is subject to tax and properly should be included in gross income.

(2) If the Commissioner finds that an application for a tentative adjustment with respect to the amortization deduction contains material omissions or errors of computation, he may disallow such application in whole or in part without further action. If, however, he deems that any error of computation can be corrected by him within the above 90-day period, he may do so and allow the application in whole or in part. The Commissioner's determination as to whether he can correct any error of computation within the above 90-day period shall be conclusive. Similarly, his action in disallowing, in whole or in part, any application for a tentative adjustment with respect to the amortization deduction will be final and may not be challenged in any proceeding. The taxpayer in such case, however, may file a regular claim for credit or refund under section 124 (d) (5) or section 322, and may maintain a suit based on such claim if it is disallowed or if the Commissioner does not act upon the claim within six months from the date it is filed.

(3) In the case of any application for a tentative adjustment with respect to the amortization deduction which is allowed in whole or in part, any increase determined in any tax previously determined which is affected by the revision of the amortization deduction or any related adjustments shall be deemed to have been determined as a deficiency and shall be assessed without regard to the restrictions on assessment provided in section 272. Such increase, for example, may be assessed without regard to whether a notice of deficiency in respect of such increase is sent to the taxpayer and without regard to whether a prior notice of deficiency has been mailed to the taxpayer. The taxpayer will not have a right to contest the assessment before The Tax Court of the United States

whether or not he is sent a notice in respect of such increase. A notice in respect of an increase determined in respect of an application for a tentative adjustment with respect to the amortization deduction, however, will constitute a notice of deficiency within the meaning of section 124 (d) (5).

(4) Each decrease determined in any tax previously determined which is affected by the revision of the amortization deduction or any related adjustment shall first be applied against any unpaid amount of the tax with respect to which such decrease was determined. Such unpaid amount of tax may include one or more of the following:

(i) An amount with respect to which the taxpayer is delinquent;

(ii) An amount (including an amount the time for payment of which has been extended under section 56 (c), but not including an amount the time for payment of which has been extended under section 3779) which is due and payable on or after the date on which the decrease is allowed; and

(iii) An amount the time for payment of which has been extended under section 3779 which is due and payable on or after the date on which the decrease is allowed.

(5) In case the unpaid amount of tax includes more than one of such amounts, the Commissioner, in his discretion, shall determine against which amount or amounts, and in what proportion, the decrease is to be applied. In general, however, the decrease will be applied against any amounts described in subparagraph (4) (i), (ii), and (iii) of this paragraph in the order named. If there are several amounts of the type described in subparagraph (4) (ii) of this paragraph), any amount of the decrease which is to be applied against such amounts will be applied by assuming that the tax previously determined minus the amount of the decrease to be so applied is "the tax" and the taxpayer had elected to pay such tax in four equal installments. The unpaid amount of tax against which a decrease may be applied may not include any amount of tax for any taxable year other than the year of the decrease. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X, which keeps its books and makes its income tax returns on the calendar year basis, filed its income tax return for 1944, showing a tax of $100,000, on March 15, 1945, and paid two installments of $25,000 each on March 15, 1945 and June 15, 1945, respectively. The corporation filed an application for a tentative adjustment with respect to the amortization deduction on September 1, 1945. The application, which showed that the corporation's income tax for 1944 as previously determined was $100,000 and that the decrease in such tax due to the revision of the amortization deduction and all related adjustments was $30,000, was allowed in full on November 30, 1945. The corporation secured an extension of time under section 56 (c) for the payment of the September 15th installment, in the amount of $25,000, of its 1944 income tax. The $30,000 decrease in the corporation's income tax for 1944 will be applied against the unpaid installments of such tax as if $70,000 (i. e., the tax previously determined minus the decrease in such tax; $100,000 minus $30,000) were the tax for 1944 and the corporation had elected to pay such tax in four equal installments. Each of the installments accordingly would be $17,500. Since the corporation paid $25,000 on March 15, 1945 and $25,000 on June 15, 1945, it in effect prepaid its September 15th installment in the amount of $15,000. The corporation therefore must pay $2,500 ($17,500 minus $15,000) upon the termination of the extension which it secured under section 56 (c) with respect to such installment, and it must pay $17,500 on December 15, 1945. The corporation will be liable for interest on the $25,000 the time for payment of which was extended under section 56 (c) as follows: Interest will be payable on $2,500 from September 15, 1945 until the date such amount is paid, and interest will be payable on $22,500 from September 15, 1945 until the date the decrease in its income tax for 1944 is allowed by the Commissioner in connection with the application for a tentative adjustment with respect to the amortization deduction.

(6) After applying the decrease against any unpaid amount of the tax decreased, the Commissioner will credit any remainder of the decrease against any increase (including interest and additions to the tax) determined in any tax as previously determined which is attributable to the revision of the amortization deduction or any related adjustments and which has been assessed under section 124 (k). Any remainder of the decrease after such application and credits may, within the above 90-day period, be credited against any income, war profits, or excess profits tax, or installment thereof, then due from the taxpayer, and, if not so credited, is to be refunded to the taxpayer within such 90-day period.

(7) The application, credit, or refund of a decrease in tax determined under

section 124 (k) shall constitute a credit or refund of an overpayment within the meaning of section 781 (b), relating to postwar credits or postwar bonds in the case of credits or refunds.

[T. D. 5500, 11 F. R. 2588]

§ 29.125-1 *In general*—(a) *Application.* Section 125 makes provision for the amortization of bond premium by the owners of the bonds.

(1) It is mandatory with respect to:

(i) Fully tax-exempt bonds (the interest on which is excludible from gross income), whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds (the interest on which is subject only to surtax) owned by a corporation.

(2) It is optional, at the election of the taxpayer, with respect to:

(i) Fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds owned by taxpayers other than corporations.

(3) The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.* (1) In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

(2) In the case of a partially tax-exempt bond to which such section is applicable, the amortizable bond premium for the taxable year is used for three purposes: (i) As an adjustment to the basis or adjusted basis of the bond; (ii) as a deduction; and (iii) as a reduction of the credit for the interst on the bond, provided in section 25 (a) (1) or (2), or section 26 (a). Accordingly, if the interest on such a partially tax-exempt bond for the taxable year is $30 and the amortizable bond premium thereon for such taxable year is $5, the $30 is included in gross income, the $5 is allowable as a deduction, an adjustment in the amount of $5 is made to the basis or adjusted basis of the bond, and the credit on account of such interest is $25 ($30 minus $5). In the case of a taxpayer whose tax is computed under Supplement T (section 400), or who elects to take the Standard deduction (section 23 (aa)), and thus no specific deduction is permitted under section 125 (a) (1) for amortization of bond premiums as such, it shall be deemed, if the taxpayer has elected to amortize bond premium in accordance with the provisions of section 125, that the deduction for amortization of amortized bond premium has been allowed for the purpose of determining the adjusted basis of the bond.

(3) In the case of a trust the income of which is distributable to the beneficiaries in whole or in part, where the trustee elects to amortize bond premium by deducting the amount thereof in the return filed for the trust on Form 1041, the distributable income of the trust determined in accordance with the provisions of section 162 (b) is the full amount otherwise distributable without reduction for amortization of bond premium in all cases where, under the law applicable to the trust or under the provisions of the trust or under the provisions of the trust instrument, the income distributable to the beneficiaries shall not be reduced by such reduction for amortization. (See section 24 (d).)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 17]

§ 29.125-2 *Bond premium and amortizable bond premium.* (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the

basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see § 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer. The application of the preceding sentence relating to adjustments may be illustrated by the following examples:

Example (1). On January 1, 1942, T, who makes his income tax returns on the calendar year basis, owns a fully taxable $100 bond, maturing on January 1, 1952. T purchased this bond on January 1, 1932, for $120. T elects to have section 125 apply to such bond for 1942 and subsequent taxable years. In determining the amount of bond premium to be amortized over the remaining 10 years of the life of the bond, T is required, but solely for such purpose, to treat the bond as if he had amortized the bond premium thereon during the prior 10 years under this section, and to make the proper adjustment in the original bond premium. Accordingly, T would treat $10 as having been amortized during the first 10 years and would be required to amortize the remaining $10 over the following 10 years. When the bond is redeemed on January 1, 1952, for $100, only the $10 attributable to the second 10 years will actually have been amortized. The $10 attributable to the first 10 years will have been treated as an adjustment to the original bond premium but will not have been amortized. Consequently T will have a capital loss in the year of redemption on account of the $10 attributable to the period 1932-1942.

Example (2). On January 1, 1942, X's father gave him a fully taxable $100 bond maturing on January 1, 1952. X's father had purchased the bond on January 1, 1932, for $120. The fair market value of the bond at the time of the gift was $130. X makes his income tax returns on the calendar year basis and elects to amortize the bond premium on the bond during the period from 1942 to 1952. Under section 113 (a) (2) the cost of the bond to X's father constitutes the basis of the bond in X's hands for determining loss, since such cost is lower than the fair market value of the bond at the time of the gift, and under section 117 (h) (2) X's holding period is deemed to include the 10 years during which his father held the bond. X is required to treat the bond as if the bond premium thereon had been amortized during his father's holding period. Thus, X is required to amortize $10 over the period 1942-1952 and in the year of redemption will have a capital loss on account of the $10 attributable to his father's holding period.

Example (3). On January 1, 1942, Y, who makes his income tax returns on the calendar year basis, owns a tax-exempt $100 bond, maturing on January 1, 1951. He purchased this bond on January 1, 1941, for $110. On December 31, 1944, Y sells the bond for $108 and thus realizes a gain of $1, computed as follows:

(1) Total bond premium ($110 minus $100)	$10
(2) Amount of bond premium amortization under section 125 (total bond premium minus unamortized bond premium attributable to 1941, $10 minus $1)	9
(3) Amount of bond premium amortized from January 1, 1942, through December 31, 1944 ($1 for each such year)	3
(4) Adjusted basis of bond at close of 1944 ($110 minus $3)	107
(5) Gain ($108 minus $107)	1

(b) Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

§ 29.125-3 *Methods of amortization.* (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

(b) A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable year beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency.

However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(c) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with § 29.125–2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

§ 29.125–4 *Election.* In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. In the case of bonds owned by a partnership, common trust fund, or foreign personal holding company, the election shall be exercisable by such partnership, common trust fund, or foreign personal holding company.

§ 29.125–5 *Callable and convertible bonds.* The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

§ 29.125–6 *Capitalized expenses.* (a) In the case of a bond on which there is no bond premium exclusive of capitalized expenses (such as buying commissions), but to which section 125 otherwise applies, a taxpayer who is required by this part to use the method of amortization prescribed by § 29.125–3, a taxpayer who regularly employs a reasonable method of amortization under which such capitalized expenses are amortized, or a taxpayer who regularly employs a reasonable method of amortization under which

such capitalized expenses are not amortized, is permitted but not required, to amortize such capitalized expenses in accordance with such method.

(b) In the case of a bond to which section 125 applies and on which there is bond premium exclusive of capitalized expenses, a taxpayer who is required by this part to use the method of amortization prescribed by § 29.125-3, must treat capitalized expenses as being part of the bond premium for the purposes of section 125, or if the taxpayer regularly employs a reasonable method of amortization under which such capitalized expenses are treated as being part of the bond premium for the purposes of amortization, such capitalized expenses must be treated as being part of the bond premium for the purposes of section 125, but if under such regularly employed method such capitalized expenses are not treated as being part of the bond premium for the purposes of amortization, the taxpayer may, but is not required to treat such capitalized expenses as being part of the bond premium for the purposes of section 125.

§ 29.125-7 *Taxable years in which interest not received or accruable.* In the case of a taxpayer who makes his income returns on the cash receipts and disbursements basis or one who makes his returns on the accrual basis and who owns a bond to which section 125 applies and in respect of which no interest is received or accrued by the taxpayer during the taxable year, if the taxpayer is required by this part to use the method of amortization prescribed by § 29.125-3, or if the taxpayer regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is amortized, or if the taxpayer regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is not amortized, amortization of bond premium on such bond for such taxable year is not required, but will be permitted in accordance with such method.

§ 29.125-8 *Bonds owned by decedents*—(a) *Cash basis decedents.* If a decedent on the cash receipts and disbursements basis owned fully taxable bonds and partially tax-exempt bonds to which section 125 applies:

(1) In the case of a fully taxable bond, the interest accruing thereon during the period ending with his death is, by reason of section 126, included upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, while the deduction on account of amortizable bond premium for such period is properly allowable as a deduction for such period under the decedent's method of accounting and is not allowable as a deduction for the estate or legatee; and

(2) In the case of a partially tax-exempt bond:

(i) The interest accruing thereon for such period is similarly included upon its receipt in the gross income of the estate or legatee, as the case may be;

(ii) The estate's or legatee's credit for such interest is not reduced on account of the amortizable bond premium for such period; and

(iii) The deduction on account of the amortizable bond premium for such period is allowable as a deduction in the return for the decedent as in the case of a fully taxable bond.

The application of the foregoing provisions relating to a partially tax-exempt bond may be illustrated by the following example:

Example. At the time of his death in 1942, D owns a partially tax-exempt bond to which section 125 applies. For the period beginning January 1, 1942, and ending with his death, the accrued interest on such bond is $25 and the amortizable bond premium is $2. D's estate has the right to receive such interest. D's executor, in making the income tax return for such period, may take into account a deduction in the amount of $2 on account of the amortizable bond premium for such period. D's estate includes the interest ($25) in its gross income upon receipt and, for the purposes of the normal tax, receives a credit for $25, which is not reduced on account of the amortizable bond premium which was a deduction allowable for the last taxable period of the decedent.

(b) *Accrual basis decedents.* If a decedent on the accrual basis owns fully taxable bonds and partially tax-exempt bonds to which section 125 applies:

(1) In the case of a fully taxable bond, both the interest accruing thereon during the period ending with his death and the deduction on acount of the amortizable bond premium for such period are allowable as deductions in the return for the decedent; and

(2) In the case of a partially tax-exempt bond, the rule as to the accrued

interest and the amortization deduction is the same as in subparagraph (1) of this paragraph, and his credit for such interest is required to be reduced by the amount of the amortizable bond premium for the period ending with the decedent's death.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.125–9 *Partially tax-exempt bonds owned by estates, trusts, partnerships, etc.* If a trust owning partially tax-exempt bonds elects to amortize the bond premium thereon under section 125, the credits of the trust and the beneficiaries on account of such interest are required to be reduced by the portion of the amortization deduction attributable to their shares of such interest. A similar rule is applied in the case of partially tax-exempt bonds owned by estates, common trust funds, partnerships, foreign personal holding companies, and personal service corporations.

§ 29.126–1 *Inclusion in gross income of income in respect of a decedent.* (a) The gross income for the taxable year of a decedent beginning on or after January 1, 1943, in which falls the date of his death, is computed upon the basis of the method of accounting followed by such decedent, even though amounts to which he is entitled as gross income are not includible under such method in computing net income for such taxable year or any prior taxable year. See § 29.42–1. Such amounts include all the accrued income of a decedent who reported his income on the basis of cash receipts and disbursements, and, in the case of a decedent who reported his income under the accrual method of accounting, such amounts include contingent items which were not accrued by the decedent and, under § 29.42–1, all items (except the amount of partnership income includible under section 182) which were accrued in the last taxable year of the decedent solely by reason of his death. For example, if the decedent who reported income on the basis of the accrual method of accounting was a member of a partnership which kept its books on the basis of cash receipts and disbursements, the decedent would be entitled at the date of his death to his distributive share of the accrued income of the partnership, although there would be included in his gross income only his distributive share of the partnership income computed on the basis of cash receipts and disbursements.

(b) Under section 126 (a) (1), all such amounts to which a decedent is entitled as gross income and which are not includible in computing his net income for his last taxable year or any prior taxable year shall be included, when received, in the gross income of the estate of the decedent or of the person receiving such amounts if such amounts are received in a taxable year ending after December 31, 1942, by the estate of the decedent or by a person entitled to such amounts by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent. These amounts are included in the income of the estate and such persons when received by them, regardless of whether or not they report income on the basis of cash receipts and disbursements.

(c) The persons who are placed with respect to such amounts in the same position as the decedent are the decedent's estate (which in the great majority of cases will be the one who receives such amounts) and, if the estate does not collect such amounts but distributes the right to receive such amounts to the heir, next of kin, legatee, or devisee who inherited or was bequeathed or devised such right, such heir, next of kin, legatee or devisee. Thus, if the decedent who kept his books on the basis of cash receipts and disbursement was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years, and his estate after collecting two installments distributed the right to the remaining installment payments to the residuary legatee of the estate, the estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

(d) Also placed in the same position as the decedent with respect to such amounts are those who acquire the right to such amounts by reason of the death of the decedent. An example of the application of this provision is the case of a decedent who owned a defense bond, with his wife as coowner or beneficiary, and who died before the payment of such bond. The entire amount accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife

when the bond is paid. Another example is the case of a partner whose partnership agreement provided that upon his death his interest in certain partnership assets would pass to the surviving partners in exchange for payments to be made by them to his widow. Upon his death, the payments by the surviving partners must be included in the widow's income to the extent they are attributable to the earnings of the partnership accrued only by reason of his death. The income reflected by the payments to the extent they are so attributable was not includible in the partner's income since it was not received by the partner (for the purposes of the cash receipts and disbursements method of accounting) and was accrued only by reason of his death (for the purposes of the accrual method of accounting). If the payments are to be made to the widow as trustee for minor children, and if the right to receive such payments is transferred to the children upon their majority, the children are within the provisions of section 126 (a) (1) as receiving the right to such payments by reason of the death of the decedent, and must include such payments when received in their income to the extent the payments are attributable to the earnings of the partnership accrued only by reason of the death.

Example. Suppose that A and the decedent B were equal partners in a business possessed of tangible assets having a present value considerably in excess of cost; suppose that certain current partnership business was well advanced toward completion prior to the death of B; and suppose that the partnership agreement provided that, upon the death of one of the partners, all partnership assets, including unfinished business, should pass to the surviving partner, and that the surviving partner should make certain payments to the estate of the decedent. To the extent that the payments by A to the estate of B are attributable to B's interest in the previously earned proportion of the unfinished partnership business transactions, their receipt by the estate of B will reflect the realization of income. With respect to such portion of the payments by A as is attributable to B's interest in the tangible assets of the partnership which had appreciated in value, no gain to the estate of B will be recognized.

If some portion of the payments by A is attributable to a sale of B's interest in partnership assets consummated by B prior to his death, however, the gain to the estate of B reflected in such payments will be recognized regardless of the character of the asset sold, and regardless of whether or not payment was due on a day which must occur after B's death.

(e) Since section 126 provides for the treatment of such amounts as income to the estate and other persons placed in the same position as the decedent with respect to such amounts, the provisions of section 113 (a) (5) with respect to the basis of property acquired by bequest, devise, or inheritance do not apply to these amounts in the hands of the estate and such persons. Furthermore, section 126 only applies to the amount of items of gross income in respect of a decedent, and items which are excluded from his gross income under section 22 (b) or section 116 are not within the provisions of section 126.

(f) If the right to receive an amount of income in respect of a decedent is transferred by the estate or the person entitled to such amount by bequest, devise, or inheritance, or by reason of the death of the decedent, the fair market value of such right at the date of the transfer shall be included in the income of the estate or of such person, plus the amount by which any consideration received on such transfer exceeds the fair market value of such right. Thus, upon a sale of such right, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in income. Similarly, if the right to receive the income is disposed of, as by gift or bequest, the fair market value of such right at the time of such disposition must be included in the gross income of the donor, testator, or other transferor. However, if the person to whom such right is transferred is a person described in section 126 (a) (1) as being entitled to such right by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent, such fair market value of the right is not included in the income of the transferor. Examples of such transfers are those by the estate to a specific legatee of such right or to the residuary legatee. Another example is the case of a trust to which is bequeathed the right of the decedent to certain payments of income. If the trust terminates and the right to such payments is transferred to the beneficiary, the trust does not include the fair market value of the right to receive such payments in its income, but such payments are included in the income of the beneficiary under the provisions of section 126 (a) (1). Under

section 126 (a) (1), the transferee in each of the above examples must include the amount, when received, in his income, and if he transfers the right to receive such amount to a person not entitled to such right by bequest, devise, or inheritance from the decedent or by reason of his death, then he must include in his income the fair market value of the right at the time of such transfer.

(g) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate or the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death as if it had been acquired in the transaction by which the decedent acquired such right, and shall be considered as having the same character it would have had if the decedent had lived and received such amount. The estate or such person is placed in the same position with respect to the nature of this income as the position the decedent enjoyed. Thus, if the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property held for more than six months, the income when received, or its fair market value if transferred, shall be treated in the hands of the estate or of such person as gain from the sale of the property, held for more than 6 months, in the same manner as if such person had held the property for the period the decedent held it, and had made the sale. Similarly, if the income is interest on United States obligations owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 25 (a) (1) and (2), as if such person owned the obligations with respect to which such interest is paid. If the amount would have constituted earned income to the decedent, as in the case of the accrued wages of a decedent who reported income on the basis of cash receipts and disbursements, such amount shall constitute earned income to the person including such amount in his gross income to the same extent as if he had engaged in place of the decedent in the transaction in which the amount was earned. Such earned income would be included with the other earned income of such person, in determining his earned income credit, and such aggregate would of course be subject to the limitations on such credit. The estate is not allowed any credit for such income which is treated as earned income in its hands, since there is no provision in Supplement E (sections 161 to 172, inclusive) allowing such a credit in the case of an estate. If the amounts received would be subject to special treatment under section 107 if the decedent had lived and included such amounts in his gross income, section 107 applies. Similarly, the provisions of sections 105 and 106, relating to the surtax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections. The surtax attributable to the inclusion of this amount in the gross income of the person receiving it shall not exceed 30 percent of such amount.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5389, 9 F. R. 7745, T. D. 5458, 10 F. R. 7335, T. D. 5459, 10 F. R. 7523]

§ 29.126–2 *Allowance of deductions and credit in respect of decedent.* (a) Under section 126 (b), the expenses, interest, and taxes described in section 23 (a), (b), and (c) for which the decedent, dying in a taxable year beginning after December 31, 1942, was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid (1) as a deduction by the estate, or (2) if the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires subject to such obligation an interest in property of the decedent. Similar treatment is given to the foreign tax credit provided by section 31. For the purposes of (2), the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of (2), to receive the right to any income in respect of a decedent. Thus, if the right to income in respect of a decedent, receivable by reason of the death of the decedent by a person other than the estate, is subject to an income tax imposed during the life of the decedent by a foreign country, which tax must be satisfied out of such income, such person is entitled to the credit provided in section 31 when he

pays this obligation. If the decedent, who reported income on the basis of cash receipts and disbursements, owned real property on which no income had accrued, but on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 23 (c) that would be allowed to the decedent if, while alive, he had made such payments.

(b) However, the deduction for percentage depletion is allowable only to the person who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, if the income results from payments on units of mineral sold by the decedent, who reported income on the basis of cash receipts and disbursements, the deduction for depletion, computed on such number of units as if the person receiving such income had the same economic interest as the decedent, shall be allowed to such person regardless of whether or not he receives any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his net income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 29.126-3 *Deduction for estate tax attributable to income in respect of decedent.* Section 126 (c) provides that the estate or person required to include in gross income any amount in respect of a decedent may deduct that portion of the estate tax on the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. This deduction is determined by first ascertaining the net value in the decedent's estate of the items which are included under section 126 in computing the income of the persons described in that section, that is, the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent described in section 126 (b). The portion of the estate tax (the sum of the basic estate tax and the additional estate tax, reduced by the credits against such taxes) attributable to the inclusion in the gross estate of such net value is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. The estate and each person receiving income in respect of the decedent may deduct as his share of such portion of the estate tax an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by the estate or such person in gross income bears to the value in the gross estate of all the items of gross income in respect of the decedent. Section 126 (c) is illustrated by the following example:

Example. X, an attorney who kept his books on the basis of the cash receipts and disbursements method of accounting, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued interest on bonds which was valued at $500. In all, $1,500 was included in his gross estate in respect of income described in section 126 (a) (1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable, and $50 for taxes accrued on certain property he owned, in all $200, for claims which represent the deductions described in section 126 (b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate is $185,000 and his net estate, computed without deducting any specific exemption, is $170,000, on which the total basic and additional estate tax (reduced by credits against such tax) is $23,625. In the year following the death of X, his estate collected the fee in the amount of $1,200, which amount is included in the income of the estate. The estate may deduct, in computing its net income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(*a*) (1) Value of income described in section 126 (a) (1) included in computing gross estate	$1,500
(2) Deductions in computing gross estate for claims representing deductions described in section 126 (b)	200
(3) Net value of items described in section 126 (a) (1)	1,300

		Item	Amount
(*b*)	(1)	Estate tax (basic and additional estate taxes, less credits against such taxes)	$23,625
	(2)	Less: Estate tax computed without including $1,300 (item (*a*) (3) above) in gross estate	23,235
	(3)	Portion of estate tax attributable to net value of income items	390
(*c*)	(1)	Value in gross estate of income received by estate in taxable year	1,000
	(2)	Value in gross estate of all income items described in section 126 (a) (1) (item (*a*) (1) above)	1,500
	(3)	Part of estate tax deductible upon receiving the $1,200 fee $\left(\frac{1,000}{1,500} \text{ of } \$390\right)$	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 126 (c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be $\frac{500}{1,500}$ of $390 or $130.

§ 29.126-4 *Income in respect of decedent dying in taxable year beginning before 1943; tax of decedent*—(a) *In general.* If the last taxable year of the decedent began before January 1, 1943, then under the law applicable to such taxable year before the enactment of the Revenue Act of 1942 all income in respect of such decedent was includible in his gross income for such taxable year, unless properly includible in gross income for a prior taxable year. See § 29.42-1. Section 134 (g) of the Revenue Act of 1942 gives the estate of the decedent and those persons entitled upon his death to receive amounts of income not includible in the income of the decedent under his method of accounting (but includible in his income under the provisions of section 42) the right to elect to have such amounts treated for tax purposes under the amendments made by the Revenue Act of 1942, that is, to exclude from the gross income of the decedent for his last taxable year any such amounts not includible therein under his method of accounting, and to include such amounts when received in the gross income of the estate and of the other persons entitled to such amounts by bequest, devise, and inheritance and by reason of the death of the decedent. The election to have these amounts treated in this manner is made by the filing of consents to such treatment by the fiduciary of the estate and by all such persons. Section 134 (g) of the Revenue Act of 1942 provides in part as follows:

(g) *Taxable years before 1943.* In case the taxable period in which falls the date of the death of the decedent began after December 31, 1933, and before January 1, 1943, the tax for such taxable period shall be computed as if provisions corresponding to the provisions of section 42 (a) and 43 of the Internal Revenue Code, as amended by subsections (a) and (b) of this section, were a part of the Revenue Act of 1934, the Revenue Act of 1936, the Revenue Act of 1938, or the Internal Revenue Code, whichever is applicable to such taxable period. In the case of the estate of such a decedent and of each person who acquires by reason of the death of such decedent or by request, devise, or inheritance from such decedent the right to receive the amount of items of gross income of the decedent which upon the application of the preceding sentence are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period, the tax for each taxable period ending on or after the date on which the decedent died shall be computed by including in gross income the amounts with respect to such decedent which would be includible, and by allowing as deductions and credits the amounts with respect to such decedent which would be allowable, if provisions corresponding to the provisions of the section inserted in the Internal Revenue Code [section 126] by subsection (e) of this section were a part of the law applicable to such taxable period. The provisions of this subsection shall not be applicable unless there are filed with the Commissioner (in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, and at the time prescribed by such regulations) signed consents made under oath by the fiduciary representing the estate and by each such person (or if any such person is no longer in existence or is under disability, by his legal representative) that with respect to such amounts the tax of the estate, or the tax of such person, as the case may be, shall be computed under the provisions of this subsection for each taxable period ending on or after the date of the death of the decedent and the tax of the decedent shall be computed under such provisions for the taxable period of the decedent in which falls the date of his death. If such consent is filed after the time for the filing of the return with respect to any such taxable period, the deficiency resulting from the failure to compute the tax for such taxable period in accordance with such consent shall be paid on the date of the filing of the consent with the Commis-

sioner, or on the date prescribed for the payment of the tax for the taxable period, whichever is later, and the period of limitations provided in sections 275 and 276 of the Internal Revenue Code * * * on the making of assessments and the beginning of distraint or a proceeding in court for collection shall with respect to such deficiency include one year immediately after the date the consent was filed, and such assessment and collection may be made notwithstanding any provision of the internal revenue laws or any rule of law which would otherwise prevent such assessment and collection. The period within which claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, with respect to any overpayment resulting from the failure to compute the tax for any such taxable period (except the taxable period of the decedent in which falls the date of his death) in accordance with such consent shall include one year immediately after the date of the filing of the consent, and credit or refund may be allowed or made notwithstanding any provision of the internal revenue laws or any rule of law which would otherwise prevent such credit or refund, but no interest shall be allowed or paid with respect to any such overpayment. The provisions of section 322 (b) (2) and (3) of the Internal Revenue Code * * * shall not apply to the refund of any such overpayment. If the application of this subsection to the taxable period of the decedent in which falls the date of his death results in a deficiency for such taxable period, and if the income tax of the decedent for such period was deducted in computing the net estate of the decedent under Chapter 3 of the Internal Revenue Code * * * and if at the time such deficiency is assessed credit or refund of any resulting overpayment in respect of the taxes imposed by such Chapter 3 * * * upon such net estate is prevented by any provision of the internal revenue laws or by any rule of law, then the amount of such deficiency which is assessed and collected shall be reduced by the amount of such resulting overpayment under such Chapter 3 * * * which would be credited or refunded if credit or refund thereof were not so prevented. This subsection shall not be deemed to change any provision of law limiting the allowance of refund or credit with respect to overpayments for the taxable period of the decedent in which falls the date of his death, and no interest shall be allowed or paid with respect to any overpayment resulting from the application of this subsection to such taxable period. If the application of this subsection to the taxable period of the decedent in which falls the date of his death results in an overpayment for such taxable period, and if such overpayment was included as part of the income tax of the decedent which was deducted in computing the net estate of the decedent under Chapter 3 of the Internal Revenue Code * * * and if, at the time such overpayment is credited or refunded the assessment and collection of deficiencies in respect of the taxes imposed by such Chapter 3 * * * upon such net estate is prevented by any provision of the internal revenue laws or by any rule of law, then the amount of such overpayment which is credited or refunded shall be reduced by the amount of the resulting deficiencies under such Chapter 3 * * * which would be assessable if the assessment and collection thereof were not so prevented.

(b) *Consents; tax of estate and persons filing consents.* (1) For the purposes of the election provided by section 134 (g) of the Revenue Act of 1942, the consents must be filed by the fiduciary of the estate and by each person who received any right to income in respect of the decedent by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent. Ordinarily, the persons who must file such consents are the administrator or the executor of the estate, the residuary beneficiary of the estate, the trustees and beneficiaries of any trust the corpus of which includes such right to income, every other specific beneficiary or such right, and every person who receives any such right by survivorship, such as the surviving joint tenants of any right to income held in joint tenancy and the surviving coowners or beneficiaries of any defense bonds owned by the decedent on which there is accrued interest not includible in his gross income under his method of accounting. If any such person is not in existence or is under legal disability, the consent may be made by his legal representative.

(2) All of such consents with respect to any one decedent shall be filed at the same time with the Commissioner of Internal Revenue, Washington, D. C. The consents must be filed not later than one year after the time prescribed for filing the return for the last taxable year of the decedent (not including any extension of time for such filing) or January 1, 1944, whichever is later.

(3) The executor, administrator, or other fiduciary of the estate (or if there is no such fiduciary, the principal beneficiary of the estate) must submit, under oath, a statement accompanying the consents and containing the following information:

(i) A list of all the items included in the gross income of the decedent for his last taxable year which would not be includible therein if the amendments made by section 134 (a) of the Revenue Act of 1942 were applicable to the rev-

enue law in effect for such taxable year. See § 29.42-1.

(ii) The amount included in gross income with respect to each of such items, the aggregate of such amounts, the value included in the gross estate of the decedent with respect to each such item for the purposes of the estate tax, and the aggregate of such values.

(iii) A list of all the items, allowed as deductions and credits in computing the net income of the decedent for his last taxable year, which would not be allowable as deductions and credits if the amendments made by section 134 (b) of the Revenue Act of 1942 were applicable to the revenue law in effect for such taxable year. See § 29.43-1.

(iv) The amount allowable as a deduction or credit with respect to each such item listed in subdivision (iii) of this subparagraph, the aggregate of such amounts, the amount of the deductions for estate tax purposes from the gross estate of the decedent in respect of claims which are founded upon that portion of such items as are described in section 126 (b), and the aggregate of such deductions.

(v) The names and addresses of every person entitled by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent to receive any amount listed in subdivision (i) of this subparagraph.

(vi) The names and addresses of every person entitled by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent to receive any property subject to an obliagtion of the decedent for which a deduction or credit described in § 29.126-2 is allowable.

(4) Each consent shall be made under oath and shall contain the following:

(i) The name and address of the person filing the consent, and the collection district in which he files his return.

(ii) The name and address of the decedent, the date of his death, the period covered by his last income tax return, and the collection district in which such return was filed.

(iii) A list of all the items (at face value) of income in respect of the decedent to which the person filing the consent was entitled by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent. If the person filing the consent is the fiduciary of the estate of the decedent, the list shall set forth every item (at face value) of income in respect of the decedent acquired by the estate from the decedent. If any items listed on the consent were collected before the time the consent was filed, or if the right to receive any such items was transferred before such time to any person not entitled to such right by bequest, devise, or inheritance, or by reason of the death of the decedent, then the list must show the amount collected in respect of each such item, or its fair market value at the time it was transferred, any consideration received for the transfer, and the date of such collection or transfer.

(iv) A list of all the items in respect of the decedent for which such person may claim deductions and credits described in § 29.126-2, showing the face value of such items, the property received by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent subject to the obligation for which any such deduction is allowed, and, if any such obligation has been paid, the amount and date paid.

(v) A recomputation of the net income and of the tax of the person filing the consent, made (*a*) for each taxable year in which any item described in subdivision (ii) of this subparagraph was collected, or in which the right to any such item was transferred to a person not entitled to such right by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent, (*b*) for each taxable year in which any item listed in (iv) was paid, or would otherwise be allowed as a deduction or credit under § 29.126-2, and (*c*) for each taxable year in which there is a carry-over or carry-back of any item from any taxable year described in (*a*) and (*b*) of this subdivision. Such recomputation shall be made under the provisions of §§ 29.126-1, 29.126-2, and 29.126-3 by including in gross income the income in respect of the decedent which is includible under section 126 (a) and by allowing as deductions and credits the deductions and credits which are allowable under section 126 (b) and (c) when section 126 is made applicable to such taxable year and when the amendments made by section 134 (a) and (b) of the Revenue Act of 1942 are made applicable to the law in effect for the last taxable year of the decedent (see §§ 29.42-1 and 29.43-1). This recomputation shall be made only

for taxable years the returns for which were due prior to the date the consent is filed. The increase or decrease in tax for each such taxable year as a result of such recomputation shall be shown, as well as the aggregate of such increases and the aggregate of such decreases.

(vi) An unqualified statement by the person filing the consent agreeing that his tax for each taxable year ending on or after the date the decedent died and the tax of the decedent for his last taxable year shall be computed under the provisions of section 134 (g) of the Revenue Act of 1942.

(5) A payment equal to the excess of the aggregate of the increases over the aggregate of the decreases in tax set out in (v) on the consent must accompany the filing of the consent. The period of limitations for assessing or collecting the increase in tax upon such recomputation for each such previous year includes one year immediately after the filing of the consents, and such assessment and collection may be made whether or not any period of limitation or any rule of law (such as a previous judicial determination of the tax liability for such year) would otherwise prevent such collection or assessment. Interest on the increase in tax for each previous taxable year is measured from the date prescribed by law for the payment of the tax for such previous taxable year. If the aggregate of the decreases in tax exceeds the aggregate of the increases in tax, the taxpayer may file claim for credit or refund of such excess, and the period of limitation for filing such claim includes one year immediately after the filing of the consents. Such credit or refund may be made whether or not any period of limitations or any rule of law would otherwise prevent such credit or refund. The amount of such credit or refund will not be limited by section 322 (b) (2) or (3). No interest will be allowed with respect to any such credit or refund.

(6) The person filing his consent must compute his tax for each taxable year, the return for which is due on or after the date the consent is filed, under the provisions of section 126 as if the amendments made by section 134 (a) and (b) were effective with respect to the revenue law applicable to the taxable year in which the decedent died. See §§ 29.42-1, 29.43-1, 29.126-1, and 29.126-2, and 29.126-3. See also 26 CFR, 1940 Supp., 19.42-1 and 19.43-1 (Regulations 103), and paragraph 8 of Treasury Decision 5233, Secretary of the Treasury, approved February 26, 1943 (8 F. R. 2554).

(c) *Tax for last taxable year of decedent if consents filed.* (1) If the consents described in paragraph (b) of this section are properly filed, the tax of the decedent for his last taxable year is computed as if the amendments made by section 134 (a) and (b) of the Revenue Act of 1942 were applicable to the revenue law in effect for such taxable year of the decedent. See §§ 29.42-1 and 29.43-1. However, no interest shall be allowed with respect to any credit or refund of any overpayment for such taxable year resulting from the application of such amendments. Furthermore, credit or refund of any such overpayment is only allowed subject to the provisions of section 322, and nothing in section 134 of the Revenue Act of 1942 makes any change in any provision of law which limits the allowance of credit or refund of an overpayment for the last taxable year of the decedent. Thus, if the claim for the credit or refund of an overpayment, caused by the application of section 134 (g) of the Revenue Act of 1942, is not filed within three years after the return for the last taxable year of the decedent was filed or two years after the last payment of tax for such taxable year was made, then no refund is allowable. If the claim is filed within such period, the refund which may be made must not exceed the portion of the tax paid within the period, preceding the filing of the claim for credit or refund, prescribed by section 322 (b) (2).

(2) In cases in which the decedent had more deductions subject to the amendment made by section 134 (b) of the Revenue Act of 1942 than income subject to the amendment made by section 134 (a) of such Revenue Act, a deficiency for his last taxable year may result from the retroactive application of such amendments under section 134 (g) of that act. Since the estate and the beneficiaries, in the filed consents, agree to the redetermination of the tax of the decedent for his last taxable year, such tax will be assessed and collected notwithstanding the prior running of any period of limitations or any other rule of law which would otherwise bar such assessment and collection.

(3) Since the income tax of the decedent for his last taxable year was deductible as a claim against his estate in

determining the estate tax, any overpayment of income tax for his last taxable year may have been an improper deduction from his gross estate. Therefore, if any such overpayment is determined for such taxable year by reason of the application of section 134 of the Revenue Act of 1942, the estate tax must then be recomputed by disallowing any deduction of such overpayment of income tax, and upon this recomputation a deficiency in estate taxes may be determined. If at the time any credit or refund of such overpayment in income tax is allowed or made, the assessment and collection of the deficiency in estate taxes are barred by any provision of the internal revenue laws or by any rule of law, then the amount of such deficiency in estate taxes is deducted from the amount which would otherwise be refunded or credited.

(4) Similarly, if there was a deficiency in income tax for the last taxable year of the decedent by reason of the application of section 134 (g) of the Revenue Act of 1942, then the deduction for income tax of the decedent in computing his net estate for estate tax purposes may have been too small, and an overpayment of estate taxes may have resulted. If credit or refund of this overpayment is barred at the time the deficiency in income taxes is assessed, the amount of the deficiency in income taxes shall be reduced by the amount of any such overpayment in estate taxes.

§ 29.127 (a)-1 *Description of war losses.* (a) Under section 127, property destroyed or seized in the course of the present war and property which is within an enemy country or an enemy controlled area on the date the United States declares that a state of war exists with the enemy country result in war losses. Property which is within an area that comes under the control of an enemy country after the date the United States declares that a state of war exists with such enemy country also results in a war loss. An investment in any of the foregoing property which loses all its value because of the war loss resulting from such property is itself treated as resulting in a war loss. Investments in such property which lose only part of their value by reason of such property resulting in a war loss are also treated, under certain circumstances, as resulting in a war loss to the extent of such loss in value. See section 127 (e).

(b) Section 127 (a) and (e) provides that the property and investments described in paragraph (a) of this section shall be treated as being "destroyed or seized" upon the date specified in the applicable subsections. That is, upon such date the taxpayer is treated as losing his entire interest in such property or investment, and this loss of such property rights is deemed to be sustained by reason of a casualty. The casualty is the destruction or seizure, whichever event the taxpayer claims occurred. If the property or investment was held for more than six months and was a capital asset or property used in the trade or business of the taxpayer, this loss (and any compensation therefor) is subject to the provisions of section 117 (j), relating to gains and losses upon involuntary conversions. See § 29.117-7. Unless such loss is treated under section 117 (j) as a loss from the sale or exchange of a capital asset, such loss is deductible as an ordinary loss under the provisions of section 23 (f) in the case of a corporation and section 23 (e) (3) in the case of an individual. The loss upon an investment which is treated under section 127 as resulting in a war loss is not subject to the provisions of section 23 (g) (2) and (k) (2) which treat losses upon worthless securities as capital losses, although such loss may nevertheless be treated under section 117 (j) as a loss upon the sale or exchange of a capital asset.

(c) For property to be treated as resulting in a war loss, such property must be in existence on the date prescribed in section 127 (a) (2) as the date it is deemed destroyed or seized or at the beginning of the period prescribed in section 127 (a) (1) or (a) (3), within which period the property is deemed destroyed or seized, and for the taxpayer to claim a loss with respect to such property he must own such property or an interest therein at such time. If, before such time, the property was destroyed or confiscated, section 127 is not applicable with respect to such property. For example, a taxpayer owned property in an enemy country before war was declared on such enemy by the United States, and such property was confiscated by the enemy before the date war was declared. The seizure was not in the course of military or naval activities. The taxpayer may not claim a war loss with respect to such property under section 127.

(d) For the purposes of section 127, the term "area" does not mean a territory or political unit but means the locality in which the property was situated.

(e) The date on which a war loss was sustained must be determined under the provisions of section 127 (a) and the regulations thereunder. The amount of loss sustained must be determined subject to the provisions of section 127 (b) and the regulations thereunder. Income to the taxpayer upon any recovery of or in respect of property or investments treated as resulting in a war loss must be determined under section 127 (c) and the regulations thereunder. The basis of any such recovery must be determined under section 127 (d) and the regulations thereunder.

§ 29.127 (a)-2 *Property destroyed or seized after the outbreak of war.* Section 127 (a) (1) has two main purposes. One is to provide that property shall be treated as destroyed or seized if it is located in an area which comes under the control of an enemy country after the date the United States declares that a state of war exists with such enemy country. This provision corresponds to the provisions of section 127 (a) (2) which give similar treatment to property located in an area under enemy control on the date the United States declares that a state of war exists with the enemy. See § 29.127 (a)-3. The other purpose of section 127 (a) (1) is to provide the method for determining the date on which such destruction or seizure is deemed to occur in cases in which the exact date when control is established cannot be determined, and to provide the method for determining the date of destruction or seizure in the case of property actually destroyed or seized in the course of military or naval operations by any country engaged in the present war if the exact date of such destruction or seizure cannot be established.

(a) *Actual destruction or seizure.* (1) Any property actually destroyed or seized in the course of military or naval operations by the United States or any other country engaged in the present war shall be deemed to have been destroyed or seized on any date chosen by the taxpayer which falls between:

(i) The latest date, as established to the satisfaction of the Commissioner, on which such property may be considered as not destroyed or seized, and

(ii) The earliest date, as established to the satisfaction of the Commissioner, on which such property may be considered as having already been destroyed or seized.

If the exact date of the destruction or seizure can be ascertained, then subdivision (i) of this subparagraph refers to the day before such date and subdivision (ii) of this subparagraph refers to the day after such date. Thus, if the taxpayer knows that his property was destroyed during a bombing raid on London on January 7, 1942, the latest date on which such property may be considered as not destroyed is January 6, 1942, and the earliest date on which it may be considered as being already destroyed is January 8, 1942. Under section 127 (a) (1), the only date the taxpayer may choose is January 7, 1942. However, in many cases the taxpayer will not be able to ascertain the exact date on which the destruction or seizure of his property occurred. In such cases the taxpayer may claim that the destruction or seizure occurred at any time he chooses between the dates prescribed in subdivisions (i) and (ii) of this subparagraph, which dates may be established on the basis of such information as the taxpayer is reasonably able to obtain. For example, the taxpayer's property was destroyed during a bombardment of a certain area which lasted several days. The taxpayer is only able to ascertain that the property was undestroyed before the bombardment, and was already destroyed when the bombardment ended. The taxpayer may treat the destruction as occurring on any date during the bombardment.

(2) Section 127 (a) (1) refers to a destruction or seizure by the United States or any other country engaged in the present war. Such other countries are the members of the United Nations, any other countries at war with enemies of the United States, and the enemies of the United States or any of the United Nations. Thus, a country which is not a member of the United Nations nor an enemy of the United States is nevertheless considered engaged in the present war if it is an enemy of any other member of the United Nations. Furthermore, the military or naval operations need not be carried on by the regular forces of the countries engaged in the present war, but it is sufficient if such operations are carried on by any forces supported by or operating in con-

junction with any such country. For example, nationals of the D country form an independent fighting force for the liberation of their country, which was conquered by an enemy of the United States, and such fighting force operates in conjunction with the forces of one or more of the United Nations. The military or naval operations of such force are considered for the purposes of section 127 (a) (1) as military or naval operations by the countries, engaged in the present war, with which such forces operate.

(3) The term "military or naval operations" in section 127 (a) (1) is used in a broad sense to cover all actions incident to belligerent activities, whether in furtherance of or in opposition to such activities. It includes operations carrying out a scorched earth policy or rendering a position under threat of attack or other danger more secure or less desirable to the attacker. For example, when invasion of a certain area by the forces of an enemy is imminent, civilians in such area burn and otherwise destroy warehouses and other property in such area. Such property is destroyed in the course of military or naval operations of the enemy. However, the orderly requisition or condemnation of property by any government, in the ordinary course of which the taxpayer is entitled to fair compensation, is not a destruction or seizure in the course of military or naval operations.

(b) *Property deemed destroyed or seized by reason of enemy control.* (1) Property in an area which, after the date the United States declares war with a country, comes under the control of such enemy country is deemed to have been seized or destroyed in the course of military or naval operations by such country. Such destruction or seizure is deemed to occur on any date chosen by the taxpayer which falls between the latest date, as determined by the Commissioner, on which the area was under the control of the United States or a country not at war with the United States, and the earliest date, as determined by the Commissioner, on which the area was under the control of the enemy country.

(2) If during the period described in the above paragraph the property in such area was actually destroyed or seized in the course of military or naval operations by any country engaged in the present war, the taxpayer may choose as the date on which the destruction or seizure occurred any date falling after whichever of the following dates is the earlier:

(i) The latest date, as established to the satisfaction of the Commissioner, on which such property may be considered as not destroyed or seized, or

(ii) The latest date determined by the Commissioner as the date on which such area was under the control of the United States or a country not at war with the United States,

and falling before whichever of the following dates is the earlier:

(*a*) The earliest date, as established to the satisfaction of the Commissioner, on which such property may be considered as having already been destroyed or seized, or

(*b*) The earliest date determined by the Commissioner as the date on which such area may be considered under the control of the country which is at war with the United States.

For example, the taxpayer has property in an area under the control of a country not at war with the United States. Such country lost control of the area on December 20, 1942, under attack by the enemy, but the taxpayer who remained in the area ascertains that the property was not destroyed on that date, but was destroyed during further fighting on January 1, 1943. An enemy country gained control of the area on February 1, 1943. The earliest date on which the taxpayer may claim the loss is December 20, 1942, the day after the latest date on which the area was under control of a country not at war with the United States. The latest date on which it may claim the loss is January 1, 1943, the day before the earliest date on which the property may be considered as having already been destroyed. An additional example is the case of a taxpayer with property in an area evacuated on December 15, 1942, when a country not at war with the United States lost control of such area. The property of the taxpayer in such area was undestroyed on such date. An enemy country established control over the area on January 21, 1943. The taxpayer learns that on July 15, 1943, the property was destroyed in a bombing raid on such area. The loss may not be claimed as occurring on any date later than January 20, 1943, the

day before the earliest date on which the enemy country was in control of the area.

(3) Whether or not a country at war with the United States gains control over intangible property by reason of its gaining control over any area is determined under the same provisions as are applicable for the purposes of section 127 (a) (2) in determining whether intangible property is subject to the control of the enemy country on the date war is declared. See § 29.127 (a)–3.

(4) In the case of any property which is within the provisions of section 127 (a) (1) by reason of any area falling under the control of an enemy of the United States, it is necessary to determine the latest date on which the United States or any country not at war with the United States was in control of such area and the earliest date on which the country at war with the United States was in control of such area. For the purposes of section 127 (a) (1), control of an area on any day means effective control which is not seriously disputed at any time during such day. For such control to exist, order must be maintained in the area, such order must be maintained by authority of the country in control, and such order must not be seriously disputed by hostile action either by elements of the civilian population or by the armed forces of any other country. Section 127 (a) (1) contemplates that in many cases there will be a lapse of time between the date when one country loses control of an area and the date when another country gains control. During this period neither country will be in control of the area, and the loss may be claimed to occur at any time during such period. The fact that any country loses control of an area is not sufficient for the purposes of section 127 (a) (1) unless a country at war with the United States gains control of such area. That is, if a country not at war with the United States, which has lost control of an area, regains control of the area before a country at war with the United States gains control, the fact that control was lost for a period of time does not cause any property in the area to be deemed to have been destroyed or seized.

(5) It should be noted that the term "area" means the locality in which the property is situated. The determination as to whether control by any country was lost or established in any area on any date will be made in a practical manner on the basis of all factors, and particular attention will be paid to the nature of the military and political operations affecting the control over such area as well as to the amount of information which can be obtained under the circumstances. For example, in view of the fact that the island of Luzon was one theater of military operations, complete control over such island by the American and Philippine forces will be considered to have ceased in December 1941, upon the beginning of the Japanese invasion of the island, and complete Japanese control will be considered to have begun in May 1942, upon the cessation of American resistance at Corregidor. In the absence of information to the contrary, control by American and Philippine forces over other Philippine islands will be considered to have ceased on the date in December 1941 when complete control of Luzon ceased, and Japanese control over such other islands will be considered to have begun on the date in May 1942 when complete Japanese control of Luzon began. Similarly, control over areas in other theaters of military or political action will be determined on the basis of the principal events in such theaters of action.

(6) A country at war with the United States may gain control over an area by its armed forces, by its civil authorities, or by obtaining control over the local authorities already established in that area. Such control over local authorities will not be deemed to exist by reason of the enemy country's domination over the government of any country if and so long as the United States maintains diplomatic relations with such government. Areas formerly subject to such government but actually taken over by armed forces or civil authorities of the enemy country are under the control of the enemy country. If the United States has not declared that a state of war exists with any country, the control by such country over any area is not deemed a destruction or seizure of property in such area, even though such country may be considered engaged in the present war by reason of its being an enemy of one of the United Nations.

(7) The latest date on which the United States or a country not at war with the United States was in control of an area, and the earliest date when an enemy of the United States was in control of an area, are questions of fact to be determined by the Commissioner on

the basis of the facts established by the taxpayer and such other information as may be in his possession. The Commissioner may from time to time issue rulings on the basis of all information then in his possession as to such dates as he has already determined with respect to any areas. Such rulings will be subject to change in the event further information is obtained. In the absence of any applicable ruling, the facts established by the taxpayer must satisfy the Commissioner that the dates chosen are proper.

(c) *Choice of date when loss deemed sustained.* (1) Section 127 (a) (1) grants the taxpayer the right to choose within the period described in paragraphs (a) and (b) of this section the date on which the destruction or seizure of property is deemed to occur. This choice of a date is exercised by claiming a gain or loss with respect to such destruction or seizure in a return for a taxable year in which such date falls, in a claim for credit or refund of an overpayment for such taxable year, or in a petition to The Tax Court of the United States with respect to such taxable year. Until the taxpayer makes such a choice upon a return, a claim, or a petition, he will be deemed to have chosen the latest date on which the destruction or seizure may be treated as having occurred. Such latest date will be considered for all purposes the date chosen by the taxpayer if the taxpayer has not chosen on a return, claim, or petition, in the manner described above, any other date by the time the return for the period in which such latest date falls is due (including any extension of time for filing such return). Thereafter, the taxpayer may choose another date only with the permission of the Commissioner. If the taxpayer has once made the choice described above by the filing of a return, a claim, or a petition in which gain or loss is claimed with respect to the destruction or seizure, such choice (whether made before or after the enactment of the Revenue Act of 1942) may not thereafter be changed except with the permission of the Commissioner.

(2) A taxpayer desiring to make a new choice of date with the permission of the Commissioner shall send a copy of his return, claim for refund, or petition in which he makes such new choice to the Commissioner of Internal Revenue, Washington 25, D. C., together with a statement of the date previously used as the date of the destruction or seizure, the new date chosen, and a recomputation of each tax imposed by the Internal Revenue Code (including income, excess profits, and declared value excess profits taxes) for each taxable year affected by such change of date. For example, if the taxpayer on the calendar year basis desires to change his choice of date from a date in 1942 to one in 1943, and if there was a carry-back of unused excess profits credit from 1942 to 1941, the taxpayer must attach to his request for permission to change his choice of date a recomputation of the tax for 1943, reflecting the tax effect of treating the destruction or seizure as occurring in that year, for 1942, reflecting the effect of treating the destruction or seizure as not occurring in such year, and for 1941, computed with the carry-back from 1942 determined by treating the destruction or seizure as occurring in 1943 and not 1942.

(3) The taxpayer must also attach to his request a statement as to whether the tax for any taxable year affected by the change of date has been determined by The Tax Court of the United States or by any court, whether a case with respect to any such tax liability is pending in any such tribunal, and whether any period of limitations or rule of law would prevent the proper adjustment of the tax liability for each such year if the change in date were permitted. The Commissioner will permit the taxpayer to change his choice of the date of the destruction or seizure if such proper adjustments may be made for each taxable year affected.

§ 29.127 (a)-3 *Property in enemy countries and enemy controlled areas.* (a) Property in a country at war with the United States, or in an area controlled by such country, on the date the United States declared that a state of war existed with such country is deemed under section 127 (a) (2) to have been destroyed or seized on such date.

(b) The term "property" includes tangible property of every kind actually within such country or area. Whether or not intangible property is within the provisions of section 127 (a) (2) depends in general upon whether the enemy country exercises the same control over such intangible property as it exercises over tangible property located within such country or area. If the enemy country may legally divest the taxpayer of his right to such intangible property

in such manner that all other jurisdictions having control of any of the obligations and assets from which such intangible property derives its value would not recognize the taxpayer as having any interest in such obligations and assets, then such intangible property is within the provisions of section 127 (a) (2). For example, a taxpayer owns stock and bonds in a corporation chartered by an enemy country. All of the assets of such corporation are in the enemy country, in a neutral country, and in a country also at war with the enemy country. The enemy country may sequester the taxpayer's interest in such stock and bonds. The neutral country recognizes the control of the enemy country over its corporation, and would not grant the taxpayer any right of recourse against the assets of the corporation located in such country. The country at war with the enemy country treats the assets of the corporation located within its jurisdiction as enemy property and would grant the taxpayer no rights in such assets during the war. The stock and bonds of the taxpayer are property within the enemy country and subject to the provisions of section 127 (a) (2). A further example is the case of a taxpayer having negotiable bonds in a corporation chartered in a neutral country. Such bonds are in the enemy country at the outbreak of the war, in the hands of an agent of the taxpayer. The neutral country does not recognize the authority of the enemy country to divest the taxpayer of his right to these bonds. Such bonds are not property subject to the provisions of section 127 (a) (2).

(c) Ordinarily, if the right of the taxpayer to the intangible property exists by reason of the law and authority of the enemy country, section 127 (a) (2) applies to such intangible property. For example, all public bonds of a country at war with the United States are considered to be within the provisions of section 127 (a) (2). On the other hand, the public bonds of a country not at war with the United States, the territory of which is occupied by a country at war with the United States on the date war is declared, are not within the provisions of section 127 (a) (2). Any interest in a corporation chartered by a country at war with the United States will be considered intangible property located in the enemy country unless the taxpayer has any rights to assets of such corporation not treated as destroyed or seized under section 127. However, any interest in a corporation chartered by a country not at war with the United States, the territory of which is occupied by a country at war with the United States, will not be considered intangible property located in an area under the control of an enemy country. Any intangible property not within the provisions of section 127 (a) (2) may be within the provisions of section 127 (a) (3), which relate to intangible property which becomes worthless by reason of war losses. See § 29.127 (a)-4.

(d) For the purposes of section 127 (a) (2), the control by the enemy country over any area may be exercised either through its military or civil agencies, or through its control over the local authorities. Thus, an area will be treated as being under the control of the enemy country if the enemy country exercises its control through the agents of a puppet government or through the local governmental organization in operation at the time it gained control of the area. Such control over local authorities will not be deemed to exist by reason of the enemy country's domination over the government of any country if the United States maintains diplomatic relations with such government. Areas formerly subject to such government but actually taken over by armed forces or civil authorities of the enemy country are under the control of the enemy country. Areas under the control of the governments of Hungary, Rumania, and Bulgaria will not be considered under enemy control prior to the date the United States declared that a state of war existed with such governments. Whether or not control by the enemy country exists is a question of fact which the Commissioner will determine on the basis of the facts established by the taxpayer and such other facts as may be in his possession.

§ 29.127 (a)-4 *Investments referable to destroyed or seized property.* (a) Section 127 (a) (3) provides that intangible property which is an interest in or with respect to underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) shall itself be treated as being destroyed or seized if it would be worthless if such underlying assets had in fact been destroyed. The intangible property may be of any kind, provided it meets the test that it would become worthless upon the actual destruction of the underlying assets treated

as destroyed or seized under section 127 (a) (1) and (2). Thus, it may be represented by accounts receivable from or by stocks, bonds, or other securities in a corporation all of the assets of which are treated as destroyed or seized under section 127 (a) (1) or (2), or by obligations of an individual, under the control of an enemy country, all of whose assets are also under the control of the enemy country. Any intangible property which derives its value from underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) is considered an interest in or with respect to such assets for the purposes of section 127 (a) (3). For example, if all of the assets owned by a holding company are securities within the provisions of section 127 (a) (3) as being issued by corporations owning only property described in section 127 (a) (1) and (2), then stock in such holding company is considered an interest in or with respect to such property described in section 127 (a) (1) and (2), and is subject to the provisions of section 127 (a) (3).

(b) For intangible property to be treated as destroyed or seized under section 127 (a) (3) the following tests must be met:

(1) Such property must be worthless if the value described in subparagraph (2) of this paragraph is disregarded; and

(2) Such property must be of a kind which would have become worthless upon the destruction of all the underlying assets which are described in section 127 (a) (1) and (2). That is, upon the date the last underlying asset described in section 127 (a) (1) or (2) is deemed destroyed or seized, there must be no other underlying asset from which such property derives a value. In applying this test as to whether the intangible property would have become worthless if the underlying assets treated as destroyed or seized under section 127 (a) (1) and (2) were actually destroyed, all interest in such assets shall be considered to have ceased as if such assets had been totally destroyed, whether or not any such asset, such as land, may ordinarily be considered indestructible. Furthermore, the value described in the paragraph (c) of this section is disregarded in determining whether such property would have become worthless.

(c) In determining for the purposes of paragraph (b) (1) and (2) of this section whether property has become worthless, any value attributable to the possibility of recovering assets treated as destroyed or seized under section 127 (a) (1) and (2) or of compensation (other than insurance or similar indemnity) for their destruction or seizure, such as an award by a government upon the completion of the war, shall be disregarded. Insurance or any other certain indemnity by a government is not disregarded. For the purposes of paragraph (b) (1) of this section any value attributable to an actual recovery in the taxable year in which the loss is claimed or, if the possibility of receiving compensation develops during such taxable year into a recognized right to compensation, attributable to such right to compensation, will prevent the intangible property from becoming worthless, and will therefore keep such property from being treated as a war loss under section 127 (a) (3).

(d) Whether or not intangible property is worthless when the underlying assets described in section 127 (a) (1) and (2) are treated as destroyed or seized is a question of fact to be established by the taxpayer. Thus, the intangible property may be worthless even though there are underlying assets which are not treated as destroyed or seized under section 127 (a) (1) and (2) if it derives no value from such other assets, as in a case in which there are obligations actually enforceable against such assets which are superior to the interest in such assets represented by the intangible property. For example, a corporation has $100,000 of assets, $80,000 of which are treated as destroyed or seized under section 127 (a) (1) and (2), and $20,000 of which are located in the United States and are not within the provisions of section 127 (a) (1) and (2). The corporation owes considerably more than $20,000 to creditors in the United States. Any stock interest in such corporation is considered worthless. If the corporation owed only $10,000 to creditors who could enforce their claims against the corporation, and owed $40,000 to creditors who are alien enemies of the United States, located in countries at war with the United States, who could not enforce their claims against the corporation, the stock is not considered worthless. The fact that any underlying assets, not under the control of a country at war with the United States, are subject to stringent controls by the United States or by any other government, such as being placed in blocked accounts or

under "freezing" controls, or otherwise under the custody of the government, will not cause any interest in such assets to be considered worthless. Such assets are merely subject to government regulation, and the interest in or with respect to such assets continues subject to such regulation.

(e) The intangible property interest described in section 127 (a) (3) is deemed to be destroyed or seized upon the date that the last of the underlying assets subject to the provisions of section 127 (a) (1) or (2) was treated as destroyed or seized under that section. In determining for such purposes when any property described in section 127 (a) (1) was destroyed or seized, the taxpayer may choose any date described in that section which he could properly choose under that section if he were the owner of such property. The choice is made by the taxpayer's claiming a loss with respect to the destruction or seizure of the intangible property described in section 127 (a) (3) in a return for the taxable year in which the date chosen falls, or in a claim for credit or refund of an overpayment for such taxable year, or in a petition to The Tax Court of the United States with respect to such taxable year. If no such choice is made, the date chosen will be deemed to be the latest date which could be chosen under section 127 (a) (1). If at the time the return for the taxable year in which such latest date falls is due (including any extension of time for filing such return), the taxpayer has not so chosen a date in a return, claim for refund, or petition, such latest date will be considered for all purposes the date chosen, and the taxpayer may not later choose any other date unless he first obtains the permission of the Commissioner. A taxpayer choosing a date by claiming such a loss on a return, claim for refund, or petition (whether or not such choice was made before the enactment of the Revenue Act of 1942) cannot change such choice unless he obtains the permission of the Commissioner. A taxpayer requesting the permission of the Commissioner in order to choose a new date must submit the same information as is required under § 29.127 (a)-2 (c) in the case of a taxpayer changing his choice of date under section 127 (a) (1), and such permission will be granted if the proper adjustments in tax liability resulting from such change may be made. The choice of date by the taxpayer must be the same for all intangible property which relates to the same property treated as destroyed or seized under section 127 (a) (1) and (2). Thus, a taxpayer owning stock and bonds in a corporation, all the assets of which are in an area that comes under the control of the enemy, cannot under section 127 (a) (3) treat the stock as destroyed or seized on one date and the bonds as destroyed or seized on another date.

(f) If a taxpayer owns 100 percent (excluding qualifying shares) of each class of stock of a corporation, it may elect for the purposes of section 127 (a) (3) to determine the worthlessness of its interest in such corporation without regard to the amount of the property of such corporation which is money in the United States, bank deposits, the right to receive money from any person not situated in a country at war with the United States or in a territory under the control of such a country, and obligations issued or guaranteed as to principal or interest by the United States, except any of such property of the corporation which is treated as destroyed or seized under section 127 (a) (1), (2), or (3) during or before the taxable year of the taxpayer in which the war loss is claimed. This exclusion of certain property of the corporation in determining worthlessness is made both for the purpose of determining whether the interest of the taxpayer in the corporation is worthless and for the purpose of determming whether such interest would have become worthless if the underlying assets of the corporation treated as destroyed or seized under section 127 (a) (1) or (2) had been destroyed. Such election is made by claiming in a return, a claim for credit or refund of an overpayment, or a petition to The Tax Court of the United States a deduction for a loss which was actually sustained upon the destruction or seizure described in section 127 (a) (3) of any interest in such corporation. The election is made for the entire interest of the taxpayer in the corporation, whether represented by stock, bonds, or otherwise, and is so made even if the taxpayer claims the loss for only a part of such interest. Such election when once made is irrevocable, although the date chosen as the date when the loss occurred may be changed with the permission of the Commissioner as in the case of other losses from a destruction or seizure described in section 127 (a) (3). For treatment of the amount of property excluded

in determining worthlessness as a recovery by the taxpayer, see § 28.127 (b)-1.

(g) For a loss to be sustained under section 127 (a) (3) with respect to any intangible property, such property must have a basis. Any intangible property treated as destroyed or seized under section 127 (a) (3) will, to the extent of the loss sustained upon such destruction or seizure, be treated as a casualty loss. Section 23 (g) (2) and (k) (2), relating to losses on certain worthless securities being treated as capital losses, does not apply to the loss on any such intangible property described in section 127 (a) (3), although such loss may, if the provisions of section 117 (j) are applicable, be treated as a capital loss under the provisions of section 117 (j). See § 29.117-7.

§ 29.127 (b)-1 *Determination of amount of war loss.* (a) The loss upon the property treated as destroyed or seized under section 127 (a) and (e) is determined as if the taxpayer's interest in such property had ceased by reason of such destruction or seizure. The loss is determined in the same manner as in the case of any other loss by casualty (see §§ 29.23 (e)-1 and 29.23 (f)-1 except that the possibility of recovering such property described in section 127 (a) or (e) or of recovering any compensation (other than insurance or similar indemnity) on account of such property or interest in the taxable year or in any future taxable year (such as the return of the property, or an award by a government, upon the termination of the war) is disregarded both in determining whether the loss is evidenced by a closed and completed transaction and in determining the amount of the loss. Insurance or any other certain indemnity by a government is not disregarded. If during the same taxable year in which the destruction or seizure is deemed to occur the taxpayer recovers the property, recovers money or other property in lieu of such property, or receives compensation for such property, or if during such taxable year the possibility of any such recovery or of receiving any such compensation develops into a recognized right to such recovery or compensation, such facts must be taken into account in determining whether any loss was sustained and, if a loss was sustained, the amount of the loss. For example, the taxpayer has property in an area under the control of an enemy country on the date war with such country is declared. Such property is deemed, under section 127 (a) (2), destroyed or seized on such date. During the taxable year of the taxpayer in which such date falls, the property is sent into a neutral country where the taxpayer recovers it. No loss is sustained by the taxpayer by reason of the destruction or seizure deemed to occur under section 127 (a) (2). If in lieu of such property the taxpayer had recovered other property in the same taxable year, the value of such other property must be taken into account as compensation for the loss sustained upon the destruction or seizure deemed to occur under section 127 (a) (2).

(b) If a taxpayer owning 100 percent of each class of stock of a corporation elects under section 127 (a) (3) (see § 29.127 (a)-4) to determine the worthlessness of his interest in such corporation without regard to certain assets of the corporation as described in section 127 (a) (3), the entire value of such assets of the corporation as of the date the taxpayer's interest in the corporation is deemed destroyed or seized under section 127 (a) (3) shall be treated as a recovery on such date by the taxpayer in determining the amount of his loss upon such destruction or seizure. Obligations of the corporation enforceable against such assets are disregarded in determining the amount of such recovery. For example, if the corporation's interest in such assets is worth $100,000, the taxpayer's recovery under the provisions of section 127 (a) (3) is considered to be $100,000, regardless of whether or not any obligations of the corporation, enforceable against such assets, are superior to the interest of the taxpayer in the corporation. Thus, if the only interest of the taxpayer in the corporation is his ownership of its stock, and if the adjusted basis of such stock is $1,000,000, his loss is $900,000 even though the corporation may have $300,000 in outstanding bonds enforceable against such assets of $100,000 and against its other assets which were not treated as destroyed or seized under section 127. (It is assumed that the stock would not be worthless, and therefore a war loss under section 127 (a) (3), if the election under section 127 (a) (3) were not made.)

(c) If, in the same taxable year in which the destruction or seizure of any property is deemed to occur, such property was used to discharge or satisfy any obligations and liabilities of the tax-

payer, or if any such obligations and liabilities are discharged by reason of the events which cause such property to be treated as destroyed or seized, the amount of such compensation must be taken into account in determining the loss upon the destruction or seizure of the property. Furthermore, the taxpayer may elect to decrease the amount of his loss in the taxable year with respect to any property treated as seized or destroyed under section 127 by the amount of his other obligations and liabilities with respect to such property if such obligations or liabilities are discharged or satisfied in a subsequent taxable year out of such property or if the taxpayer is unable to determine at the time of the election whether or not such obligations or liabilities are so discharged or satisfied. The determination of the amount of the loss where there are obligations and liabilities with respect to destroyed or seized property is illustrated by the case of a bank having a branch in Rumania, the assets of which are treated under section 127 (a) (2) as destroyed or seized on the date war is declared with Rumania. In determining the loss upon such assets, consideration must be given to the compensation for the destruction or seizure resulting from the assets being used in the same taxable year to discharge the bank's liabilities to depositors in the branch. Furthermore, if the bank establishes that any liabilities to depositors were discharged out of the assets in a subsequent taxable year, or if the bank establishes that it is unable to determine whether or not any such liabilities are discharged out of the assets, it may elect to decrease the amount of the loss with respect to the assets in the branch by all such liabilities. If it is determined that any liabilities will not be discharged out of the assets, the bank may not decrease the amount of the loss by the amount of such liabilities.

(d) The election described in this section to decrease the amount of the loss by obligations and liabilities with respect to the destroyed or seized property is made by so decreasing the loss in claiming a deduction therefor in the return (or if such return was filed on or before March 15, 1943, in an amendment thereto filed on or before July 1, 1943), in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to the taxable year in which the loss was sustained, and by attaching to such return (or such amendment thereto filed on or before July 1, 1943) as a part thereof, or by including in such claim a statement as to the obligations and liabilities involved, the property to which they relate, and such facts as are in the taxpayer's knowledge. If the loss is claimed in a petition to The Tax Court, such statement, made under oath, should be attached to a copy of the petition and sent to the Commissioner of Internal Revenue, Washington, D. C. The election when once made may be changed only with the permission of the Commissioner. The election must be made as to all the obligations and liabilities described in this section with respect to the same property, and applies to all such obligations and liabilities if made as to any of them.

§ 29.127 (c)-1 *Recoveries included in gross income.* (a) A taxpayer who has sustained a war loss described in section 127 must include in his gross income for each taxable year, to the extent provided in section 127 (c), the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 127 (c) provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 of the Internal Revenue Code, that is, of any income tax of the taxpayer. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable year for which they were allowed, beginning with the latest. See § 29.127 (f)-1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of his allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1. Any further recoveries in

excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction or seizure, and such gain is recognized or not recognized under the provisions of section 112 (f). See § 29.112 (f)-1. Such gain, if recognized, is included in gross income as ordinary income unless section 117 (j) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See § 29.117-7.

(b) The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property, both determined as of the date of the recovery. The recoveries in respect of any war loss include the recovery of the property or interest treated as destroyed or seized under section 127 and the recovery of any money or property in lieu of such property or interest or on account of the destruction or seizure of such property or interest. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as resulting in a war loss because it was located in a country at war with the United States. An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery under section 127 (c). The amount obtained upon the sale or other transfer by the taxpayer of his right to any property treated as resulting in a war loss is also a recovery for the purposes of section 127 (c). Similarly, if a taxpayer who sustained a war loss under section 127 (e) upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as destroyed or seized under section 127 (a) (1) or (2), any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of section 127 (c). Furthermore, if any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127 (a) (3) (see § 29.127 (a)-4), or if the taxpayer retained an interest in a corporation with respoct to which he sustained a war loss under section 127 (e), and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as destroyed or seized under section 127, then such restoration in value is a recovery by the taxpayer for the purposes of section 127 (c).

(c) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(1) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code, as determined under § 29.127 (f)-1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(2) The amount of the recoveries for any day which is not excluded from gross income under subparagraph (1) of this paragraph is included in gross income as ordinary income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion, if any, of the amount of the recoveries for such day which is not included in gross income under subparagraph (1) of this paragraph.

(3) The amount of the recoveries for any day which is not excluded from gross income under subparagraph (1) of this paragraph and is not included in gross income as ordinary income under subparagraph (2) of this paragraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(i) Such gain is recognized or not recognized under the provisions of section 112 (f), relating to gain upon such conversion of property. For the purpose of applying section 112 (f), such gain for any day is deemed to be expended in the manner provided in section 112 (f) to the extent the recovery for such day is so expended.

(ii) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 117 (j) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 117 (j), such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(iii) Section 127 (d) provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purposes, the recognized gain deemed to be derived from properties described in section 117 (j) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 117 (j) may be similarly allocated. The total gain derived from any recovery property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(d) The foregoing provisions may be illustrated by the following examples:

Example (1). The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 29.127 (f)-1. In a subsequent taxable year, he received an award of $800 from the Government on account of property A. This is not included in income since it is less than tne amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit, $1,000, exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit, or $1,000, exceed the sum of all previous recoveries, or $800. All of the remaining $1,300 of the recovery is included in gross income as ordinary income. and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses, or $3,000, exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and $1,500, or $2,300), note of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 112 (f). Thus, it is not recognized if it is forthwith expended for the acquisition of property related in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800+$1,500+$2,500, or $4,800), all of the recovery with respect to D. is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 112 (f), this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127.

Example (2). The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated under section 127 as destroyed or seized in a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not recognized under section 112 (f), leaving $3,000 of recognized gain. Property B is within the provisions of section 117 (j), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 117 (j) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000

or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 117 (j).

For the purposes of section 127 (c), the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery. If property is treated as destroyed or seized under section 127, and if in the same taxable year there is also a recovery with respect to such property, such recovery is not within the provisions of section 127 (c) but is taken into account under section 127 (b) in determining the amount of the loss, if any, on the destruction or seizure. See § 29.127 (b)-1. An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any property or interest being treated as destroyed or seized under section 127, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer, in computing his tax for any taxable year, and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5454, 10 F. R. 5501]

§ 29.127 (d)-1 *Basis of recovered property.* (a) Under section 127 (d), the unadjusted basis of any property treated as a war loss under section 127 which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(1) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property, as determined under § 29.127 (c)-1.

(2) Such fair market value, as reduced under subparagraph (1) of this paragraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property, as determined under § 29.127 (c)-1.

(b) In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 29.127 (c)-1.

(c) If the respective bases of several properties of a taxpayer determined under section 127 (d) are greatly disproportionate to their adjusted bases immediately prior to their being treated as destroyed or seized under section 127, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately prior to the destruction or seizure of such properties determined under section 127. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under paragraph (b) of this section.

(d) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately prior to the destruction or seizure of such property determined under section 127, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately prior to the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under paragraph (a) of this section that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property

which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery. For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(e) The amount of any adjustments to the unadjusted basis determined under paragraph (a) of this section shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under paragraph (a) of this section, and if the unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(f) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or more must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

§ 29.127 (e)-1 *Cases in which liquidation of corporation causes war loss.* Section 127 (e) provides that in a limited class of cases a portion of the loss by a taxpayer upon the liquidation of a corporation will be treated as a war loss resulting from the destruction or seizure of an allocable part of the interest of the taxpayer in the corporation. The war loss is sustained at the time the loss upon the liquidation is sustained. The taxpayer sustains a war loss only if section 127 (e) applies to the loss sustained by him upon the liquidation of the corporation, and only in the amount determined under that section. The provisions of section 127 (b), (c), and (d), and the regulations thereunder, which apply to a war loss determined under section 127 (a) (3) also apply to a war loss determined under section 127 (e).

(a) *Application of section 127 (e).* Section 127 (e) applies only if all of the following provisions are met:

(1) The taxpayer must own not less than 50 percent of each class of stock of the corporation at the time of the liquidation described below and at all times when any property of the corporation described in section 127 (a) is deemed destroyed or seized.

(2) Property of the corporation representing at least 75 percent of the adjusted basis for determining loss of all the property of the corporation must be deemed destroyed or seized under the provisions of section 127 (a) (1) or (2), relating to property actually destroyed or seized during military or naval operations or located in an enemy country or in an area under the control of such country. For the purposes of this provision:

(i) The adjusted basis for determining loss of all the property of the corporation is determined as of the date immediately preceding the first date on which any property of the corporation is deemed destroyed or seized under the provisions of section 127 (a) (1), (2), or (3), except that if such determination would produce a greater amount if made as of any later date falling within or before the taxable year in which the loss is sustained, it is made as of such later date on which it produces the greatest amount. If any property of the corporation which is at no time treated as destroyed or seized under section 127 (a) is money in the United States, bank deposits, the right to receive money from any person not situated in a country at war with the United States or in a territory under the control of such a country, or obligations issued or guaranteed as to principal or interest by the United States, then the adjusted basis of such property shall not be taken into account in determining the adjusted basis of all the property of the corporation.

(ii) The property of the corporation described in section 127 (a) (1) or (2) deemed to be destroyed or seized repre-

sents at least 75 percent of the amount determined under (i) above as the adjusted basis for determining loss of all the property of the corporation if the aggregate of the adjusted bases for determining loss of all such property described in section 127 (a) (1) or (2) (determined for each such property as of the date prescribed under subdivision (i) of this subparagraph, except that the date immediately preceding the date it is deemed destroyed or seized shall be used if the property was not held by the corporation on the date prescribed in subdivision (i) of this subparagraph or was deemed destroyed or seized on or before such date) is not less than 75 percent of the amount so determined under subdivision (i) of this subparagraph. The property described in section 127 (a) (1) or (2) which is included in determining such 75 percent amount is property owned by the corporation, for the destruction or seizure of which it could claim a war loss under section 127 (a) (1) or (2). Property of the corporation deemed destroyed or seized under section 127 (a) (3) is not included in determining such 75 percent amount even though such property may be an interest in property described in section 127 (a) (1) or (2).

(3) The corporation must completely liquidate within one year after the last property of the corporation described in section 127 (a) (1) or (2) is deemed destroyed or seized under such section, except that if such year expires before April 21, 1943 (the last date falling within six months after the enactment of the Revenue Act of 1942), the liquidation may be completed on or before that date. The corporation has completely liquidated if it has distributed to its shareholders all the assets which it is able to distribute and all its rights to assets, such as assets treated as war losses under section 127 (a) (1) or (2), which it is not able to distribute. Dissolution of the corporation is not necessary if the distribution otherwise results in a complete liquidation. In some cases the corporation may not be able to comply with certain formalities required by the law applicable in the case of a liquidation. For example, a corporation chartered by a foreign government not at war with the United States may be required to hold its shareholders' meetings, at which any liquidation must be approved, in a city occupied by the forces of a country at war with such government and with the United States; due to the occupation of that city by the enemy country the shareholders' meeting, approving the liquidation, is held at some other place. In such cases, the validity of the liquidation will be determined on the basis of whether the corporation in good faith has complied as fully as possible with all provisions of law applicable to such liquidation. The liquidation will not be considered invalid because of the absence of any formalities incident to such liquidation with which the corporation was not able to comply, unless such liquidation is actually declared invalid by any appropriate authority. If a war loss upon any such liquidation has been allowed upon audit by the Commissioner, if the taxpayer attached a statement to the return in which such loss was claimed, as a part thereof, to the effect that he had determined to consider the liquidation valid for all purposes, including the treatment as a recovery by him for the purposes of section 127 (c) of any recovery with respect to the assets and rights to assets distributed to him, and if the taxpayer in such statement waived the benefits of any period of limitations which would prevent the adjustment of his tax liability on account of the invalidity of the liquidation at any time at which he should contend that the liquidation was invalid and the Commissioner should agree to permit him so to change his position, then (in the absence of such change of position with the permission of the Commissioner) the war loss will not be subsequently disallowed even though the liquidation may be declared invalid by some appropriate authority.

(b) *Determination of amount of war loss.* (1) If the provisions of paragraph (a) of this section are met, the loss sustained by the taxpayer upon the liquidation described in such paragraph is considered a war loss to the extent it is attributable to the property of the corporation described in section 127 (a) (1) or (2) which is deemed destroyed or seized. The loss sustained by the taxpayer upon the liquidation of the corporation is attributable to property of the corporation described in section 127 (a) (1) or (2), which is deemed destroyed or seized, to the extent that such loss would be decreased (but not decreased below zero) if the corporation at the time of the liquidation owned additional assets, which it could distribute, having a fair market value equal to that

of the property described in section 127 (a) (1) or (2), determined for each such property as of the date immediately preceding the date it is deemed destroyed or seized. The amount of the war loss sustained by the taxpayer is the amount of such decrease. For example, a taxpayer described in paragraph (a) of this section sustained a loss of $1,000 upon a liquidation described in such subsection. If the corporation owned additional distributable assets at the time of the liquidation having a fair market value equal to that of its property described in section 127 (a) (1) or (2) (determined as of the date immediately preceding the date such property is deemed destroyed or seized), it would have distributed $800 of such assets to the taxpayer, and his loss upon the liquidation would accordingly have been reduced by this amount. Therefore, $800 of the $1,000 loss sustained by the taxpayer is attributable to the property of the corporation described in section 127 (a) (1) or (2), and the taxpayer has a war loss of $800. The remaining $200 loss sustained on the liquidation has the same character it would have had if section 127 (e) had not applied to any portion of such loss.

(2) If the taxpayer has more than one kind of stock or other interest in the corporation, the determination of the war loss by reference to the decrease in the loss on the liquidation must be made for each such interest, since to the extent the loss on any such interest would be reduced below zero (by the distribution of the assets equal in value to the property described in section 127 (a) (1) or (2)) no war loss is sustained by the taxpayer. For example, the taxpayer owns stock A and stock B in the corporation, and upon its liquidation he sustains a loss of $1,000 with respect to A and of $2,000 with respect to B, or $3,000 in all. Upon a distribution of assets equal in value to the property of the corporation described in section 127 (a) (1) or (2), the taxpayer would receive $1,800, reducing his loss on the liquidation by that amount. However, of this $1,800, $1,200 would be received with respect to the A stock, for which the loss on the liquidation was only $1,000. Therefore, only $1,000 of the amount received with respect to the A stock is a war loss. $600 would be received with respect to the B stock, and all of this amount is a war loss since it would not reduce the $2,000 loss on B below zero. Therefore, the war loss of the taxpayer on the liquidation is $1,600 ($1,000 plus $600) and not the $1,800 computed on the basis of the taxpayer's total interest in the corporation.

(3) For the purposes of this paragraph, the loss sustained by the taxpayer upon the liquidation described in paragraph (a) of this section is determined under sections 111 and 115. Such loss is determined without regard to the provisions of section 112, relating to the nonrecognition of gains and losses upon certain exchanges, but such provisions apply to that part of the loss which is not treated as a war loss. In determining the loss of the taxpayer upon the liquidation, no value shall be ascribed to the possibility of a recovery of the property of the corporation described in section 127, deemed destroyed or seized, the rights to which are distributed to him, or of compensation (other than insurance or similar indemnity) on account of its destruction or seizure. Any recovery in the taxable year with respect to such rights is taken into account under section 127 (b) in determining the amount deductible on account of the war loss.

(4) The war loss described in this section is deemed to result from the destruction or seizure of the taxpayer's interest in the corporation to which it is allocable. Therefore, this war loss, in the amount determined under section 127 (b) (see § 29.127 (b)-1), is deductible as an ordinary loss by casualty unless under section 117 (j), relating to losses on the involuntary conversion of certain property, it is treated as a loss on the sale or exchange of a capital asset. If part of the taxpayer's stock or other interests in the corporation is property described in section 117 (j), and part is not, then for the purposes of section 117 (j) the war loss must be allocated to the various interests in the corporation. The portion of any interest in the corporation to which any part of the war loss is allocable is deemed destroyed or seized under section 127 (e), and the part of the war loss allocated to such interest is deemed to result from such destruction or seizure. The allocation of the war loss among the stock and other interests of the taxpayer in the corporation is made as follows:

(i) The war loss is apportioned among the stock and other interests of the taxpayer in the corporation in the amounts

by which the losses with respect to such interests, sustained upon the liquidation, would be decreased if the corporation had distributed, as described above for the determination of the amount of the war loss, assets equal in value to its property described in section 127 (a) (1) or (2). The war loss is allocable to that part of the stock or other interest of the taxpayer which is the same portion of such interest as the war loss apportioned to such interest is of the loss with respect to such interest sustained upon the liquidation.

For example, the taxpayer owns stock of class A and stock of class B in a corporation. Upon the liquidation described in paragraph (a) of this section it sustains a loss of $1,000 on the A stock and $2,000 on the B stock, a total loss of $3,000. If the corporation had distributed assets equal in value to its property described in section 127 (a) (1) or (2), the taxpayer would have received $1,400, $1,000 with respect to A and $400 with respect to B, reducing his loss on each by such amount. Therefore, of his $1,400 war loss, $1,000 is apportioned to A and $400 to B. The war loss is allocable to all of the A stock $\left(\frac{\$1{,}000 \text{ war loss}}{\$1{,}000 \text{ liquidation loss}} \text{ times A}\right)$, and the $1,000 war loss apportioned to the A stock is deemed to result from its destruction, or seizure. Similarly, the war loss is allocable to 20 percent of the B stock $\left(\frac{\$400 \text{ war loss}}{\$2{,}000 \text{ liquidation loss}} \text{ times B}\right)$, and the $400 war loss apportioned to B is deemed to result from the destruction or seizure of a 20 percent interest in the B stock owned by the taxpayer.

§ 29.127 (f)-1 *Determination of tax benefits from allowable deductions.* (a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102), or victory tax of the taxpayer, or of any tax imposed in lieu of such taxes, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carry-over or carry-back of net operating losses from the taxable year in which such deductions are allowed, is considered for the purposes of section 127 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 22 (b) (12) apply, such as bad debts, the determination of the tax benefit should be made in accordance with § 29.22 (b) (12)-1 (b). The deductions allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127 which (1) was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to The Tax Court of the United States and (2) was not allowed as a deduction (for example, by the Commissioner, a court, or The Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 127 (c) that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127 (b) to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the

war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5454, 10 F. R. 5501]

§ 29.128-1 *Recovery of unconstitutional taxes*—(a) *In general.* (1) Subject to the limitations herein, a taxpayer who recovers unconstitutional Federal taxes, such as taxes imposed by the Agricultural Adjustment Act, which were paid or accrued and for which a deduction was allowed in a prior taxable year is entitled at his election (see paragraph (b) of this section) to exclude the income (exclusive of interest) attributable of such recovery from his gross income in the taxable year of recovery.

(2) In the event a taxpayer elects to receive the benefits of section 128 the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in prior taxable years. The taxpayer's return for the prior taxable year or years with respect to which the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any, and only if the taxpayer consents in writing to the assessment (see paragraph (b) of this section). No other adjustment will be allowed.

(3) In the event the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed within the period agreed upon between the taxpayer and the Commissioner, in respect of the taxable year of the prior deduction, against the taxpayer (who must file a written consent to the assessment as provided in paragraph (b) of this section) even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 128 to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall from the standpoint of its inclusion in or exclusion from gross income be governed by the provisions of section 22 (b) (12).

(5) Where a taxpayer's liability for income tax with respect to the deduction or the recovery or with respect to the tax liability for the year of the deduction or recovery has been finally determined by a written agreement or by a decision of The Tax Court of the United States or of any court, the taxpayer will not be entitled to the benefits of section 128 or of this section. As to taxability of refund of taxes generally, see section 22 (b) (12).

(b) *Manner of making election.* (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing with the Commissioner a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. Where the recovery antedates February 10, 1943 (the date of approval of Treasury Decision 5226), the statement of election must be filed within 90 days after such approval date. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to the Commissioner's treating the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the Commissioner's assessing, in respect of the taxable year for which the deduction was allowed, any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired prior to the filing of such consent.

(2) As used in this section the term "recovery" includes not only refund or credit of taxes previously paid, but includes also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

ACQUISITIONS TO EVADE OR AVOID INCOME OR EXCESS PROFITS TAX

§ 29.129-1 *Meaning and use of terms.* As used in section 129 and in §§ 29.129-2 to 29.129-5:

(a) The term "allowance" refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, or exemption, or an exclusion.

(b) The phrase "evasion or avoidance" is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) The phrase "Federal income or excess profits tax" refers to any Federal tax imposed by Congress upon an income base.

(d) The term "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. To "acquire, on or after October 8, 1940. . . . Control", it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940 and at all times thereafter, owns 40 percent of the stock of Corporation X and acquires on October 8, 1940 an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940 such assets to a newly organized Corporation Y in exchange for all the stock of Corporation Y, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Corporation C, then an acquisition within the meaning of such phrase is also made by Corporation C on October 8, 1940, by the shareholders taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of C on such date.

(e) The term "person" includes an individual, a trust, an estate, a partnership, a company, or a corporation.

[T. D. 5426, 10 F. R. 23]

§ 29.129-2 *Purpose and scope of section 129.* (a) Section 129 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income or excess profits taxes. See § 29.129-3.

(b) Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are *Gregory* v. *Helvering,* (1935) 293 U. S. 465; *Griffiths* v. *Helvering,* (1939) 308 U. S. 355; *Higgins* v. *Smith,* (1940) 308 U. S. 473; and *J. D. and A. B. Spreckels Co.* v. *Commissioner,* (1940) 41 B. T. A. 370. In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 24 (b) and (c) and section 130, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 129 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately.

[T. D. 5426, 10 F. R. 23]

§ 29.129-3 *Instances in which section 129 (a) disallows a deduction, credit, or other allowance.* (a) Section 129 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in

(1) and (2) of section 129 (a), are those in which:

(1) Any person or persons acquire, directly or indirectly, on or after October 8, 1940, control of a corporation; and

(2) Any corporation acquires, directly or indirectly, on or after October 8, 1940, property of another corporation (not controlled, directly or indirectly, immediately prior to such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is a substituted basis.

(b) In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy. The principal purpose actuating the acquisition must have been to secure the benefit which such person or persons or corporation would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

(c) If the requisite acquisition and purpose exist, among the transactions within (1) of section 129 (a) are the following:

(1) A corporation (or the interest controlling such a corporation) with large profits acquires control of another corporation with current, past, or prospective credits, deductions, net operating losses, unused excess profits credits, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income; or

(2) A corporation with large profits transfers the assets of each of its branches or departments to newly organized corporations in order to secure the benefit of the exemption provided in section 710 (b) (1); or

(3) A corporation with high earning assets transfers them to a newly organized subsidiary retaining assets likely to produce losses or to be diposed of at a loss for the purpose of securing refunds through a utilization of the unused excess profits carry-back or the net operating loss carry-back.

(d) If the requisite acquisition and purpose exist, among the transactions within (2) of section 129 (a) is the following:

(1) A corporation acquires property having in its hands a substituted basis which is materially greater than its fair market value at the time of such acquisition in order to secure a larger excess profits credit or to utilize the property to create tax-reducing losses.

[T. D. 5426, 10 F. R. 24]

§ 29.129-4 *Power of Commissioner to allocate deduction, credit, or allowance in part.* The Commissioner is authorized by subsection (b) of section 129 to allow a part of the amount disallowed by section 129 (a), but he may allow such part only if and to the extent that he determines that the amount allowed will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made. The Commissioner is also authorized to use other methods to give effect to part of the amount disallowed under subsection (a) of section 129 but only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made. Whenever appropriate to give proper effect to the deduction, credit, or other allowance, or such part of it which may be allowed, this authority includes the distribution, apportionment, or allocation of both the gross income and the deductions, credits, or other allowances the benefit of which was sought, between or among the corporations, or properties, or parts thereof, involved, and includes the disallowance of any such deduction, credit, or other allowance to any of the taxpayers involved.

[T. D. 5426, 10 F. R. 24]

§ 29.129-5 *Taxable years to which applicable.* The provisions of section 129 apply to taxable years beginning after

December 31, 1943. A deduction, credit, or other allowance which would be disallowed by section 129 if that section were applicable to taxable years beginning prior to January 1, 1944 is nevertheless disallowed if its disallowance is required under any applicable law or rule of law.

[T. D. 5426, 10 F. R. 24]

§ 29.130-1 *Limitation on deductions allowable to individuals in certain cases*—(a) *Recomputation of net income.* (1) Section 130 serves to limit the deductions, other than taxes and interest, attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1. If in each of five consecutive taxable years the deductions attributable to a trade or business, except the deduction for interest and except the deduction for taxes, exceed the gross income derived from such trade or business by more than $50,000, the net income of such individual must be recomputed for each of such five taxable years. In recomputing the net income for each of the five taxable years, deductions (other than those for interest and taxes) attributable to the trade or business, and otherwise allowable under chapter 1, shall be allowed only to the extent of:

(i) The gross income derived from the trade or business, plus

(ii) $50,000.

The deduction for interest and the deduction for taxes shall each be allowed in full. The net operating loss deduction provided in section 23 (s), to the extent attributable to the given trade or business, shall be disallowed in its entirety in making such recomputation. Thus, any carry-over or carry-back of a net operating loss, so attributable, either from a year within the period of five consecutive taxable years or from a year outside of such period, shall be ignored in making the recomputation of net income. However, the net operating loss deduction provided in section 23 (s) shall be included in determining whether the deductions (other than the deduction for interest and the deduction for taxes), otherwise allowable under chapter 1, which are attributable to a trade or business exceed the gross income derived from such trade or business by more than $50,000 in any taxable year. The limitations on deductions provided by section 130 are applicable in determining under section 122 the amount of any net operating loss carry-over or carry-back from any year which falls within the provisions of section 130 to any year which does not fall within such provisions. Also in determining under section 122 the amount of any net operating loss carry-over from a year which falls within the provisions of section 130 to a year which does not fall within such provisions, the amount of the net operating loss is to be reduced by the net income (determined after the application of section 130 and computed as provided in § 29.122-4 (c)) of the two preceding taxable years and of the first succeeding taxable year if such first succeeding taxable year falls within the provisions of section 130, even though the net operating loss deduction is not an allowable deduction for such succeeding or preceding taxable years.

(2) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses, and the gross income derived from such trades or businesses, shall not be aggregated in determining whether the deductions (other than those for interest and taxes) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. Each trade or business shall be considered separately. The trade or business carried on by the individual must be the same in each of the five consecutive taxable years in which the deductions (other than those for interest and taxes) exceed the gross income derived from such trade or business by more than $50,000.

(3) For purposes of section 130, a given taxable year may be part of two or more different periods of five consecutive taxable years. Thus, if the deductions, other than taxes and interest, attributable to a trade or business carried on by an individual exceed the gross income from such business by more than $50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(b) *Redetermination of tax.* The tax imposed by chapter 1 for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the net income of the individual recomputed in the manner described in paragraph (a) of

this section. If the assessment of a deficiency is prevented (except for the provisions of section 3801, relating to mitigation of effect of limitation and other provisions in income tax cases, or 3807, relating to period of limitation in case of related taxes under chapter 1 and chapter 2) by the operation of any provision of law (e. g., sections 275 and 276, relating to the period of limitation upon assessment and collection) except section 3761, relating to compromises, or by any rule of law (e. g., res judicata), then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for purposes of section 130. The term "tax previously determined" shall have the same meaning as that assigned to such term by section 3801 (d). See § 29.3801 (d)-1.

(c) *Assessment of tax.* Any amount determined as a deficiency in the manner described in paragraph (b) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 130, the amount of the actual deficiency as defined in section 271 (whether it is greater than, equal to, or less than the deficiency determined under section 130 (b)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e. g., the period of limitation upon the assessment of tax) except section 3761, relating to compromises, or by the operation of any rule of law (e. g., res judicata), then the excess of the tax recomputed as described in paragraph (b) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 271, in respect of the given taxable year.

(d) *Years to which applicable.* The provisions of section 130 are applicable to taxable years beginning after December 31, 1939, but no deficiency shall be assessed pursuant to such section for any taxable year beginning prior to January 1, 1944. Thus, if an individual makes his tax returns on the basis of a calendar year and if the deductions (other than those for interest and taxes) attributable to a trade or business carried on by such individual which are otherwise allowable under chapter 1 exceed the gross income derived from such trade or business by more than $50,000 in each of the taxable years 1940, 1941, 1942, 1943, and 1944, the net income of such individual for the year 1944 is to be recomputed and a deficiency, as defined in paragraph (b) of this section, may be assessed in respect of the taxable year 1944. No such deficiency, however, may be assessed in respect of the years 1940, 1941, 1942, or 1943.

[T. D. 5399, 9 F. R. 10296]

CREDITS AGAINST TAX

§ 29.131-1 *Analysis of credit for taxes.* (a) If the taxpayer chooses to claim a credit for taxes, the basis of such credit, in the case of a citizen of the United States, whether resident or nonresident, and in the case of a domestic corporation, is as follows: (1) The amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (2) an individual's proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(b) In the case of an alien resident of the United States who chooses to claim a credit for such taxes the basis of the credit is as follows: (1) The amount of any such taxes paid or accrued during the taxable year to any possession of the United States; (2) the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country, and (3) his proportionate share of any such taxes of a partnership of which he is a partner or of an estate or trust of which he is a beneficiary paid or accrued during the taxable year to any possession of the United States, or to any foreign country, as the

case may be, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.

(c) If a taxpayer chooses to claim a credit for taxes, such action will be considered to apply to income, war-profits, and excess-profits taxes paid to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income.

(d) The choice available to the taxpayer with respect to claiming such credit may be exercised (or changed if previously exercised) by the taxpayer at any time prior to the expiration of the period prescribed by statute for the making of a claim for credit or refund for the taxable year. For disallowance as a deduction of foreign income, war-profits, or excess-profits taxes in the event such choice is made, see § 29.23 (c)-1.

(e) For taxable years beginning before January 1, 1943, no credit for taxes shall be allowed against the tax imposed under section 102, relating to surtax on corporations improperly accumulating surplus, and for taxable years beginning after December 31, 1942, credit for taxes shall be allowed neither against the tax imposed under section 102, relating to surtax on corporations improperly accumulating surplus, nor against the victory tax imposed under section 450.

(f) A citizen of the United States or a domestic corporation entitled to the benefits of section 251, or a China Trade Act corporation, is not allowed any of the credits provided by section 131.

§ 29.131-2 *Meaning of terms.* The term "amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the taxpayer claiming credit. For the purposes of section 131 and section 23 (c) (1) the term "income, war-profits, and excess-profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if (a) such country or possession has in force a general income tax law, (b) the taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and (c) such general income tax is not imposed upon the taxpayer thus subject to such substituted tax. For example, the A Corporation does business in the X country, which imposes an income tax upon substantially a net income base. The ascertainment of net income, though not the determination of gross income, from sources in X country is found administratively difficult. The X country, by decree, provides that corporations circumstanced as was the A Corporation would, in lieu of the income tax at the rate of 20 percent otherwise payable, be subject to tax at the rate of 10 percent upon the amount of gross income from X country. In accordance with such decree, the A Corporation paid X country the sum of $25,000 in 1943 with respect to its tax liability to the X country for the year 1942. Such amount, subject to the applicable limitations, is available as a credit to the A Corporation as foreign income, war-profits, or excess-profits taxes against the United States tax liability for the year 1942. "Foreign country" means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income, war-profits, or excess-profits taxes. "Any possession of the United States" includes, among others, Puerto Rico, the Philippines prior to July 4, 1946, and the Virgin Islands. But see section 251. As to the meaning of "sources" see section 119. (See also section 3797.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5534, 11 F. R. 9553]

§ 29.131-3 *Conditions of allowance of credit.* (a) If the taxpayer does not signify in his return his desire to claim credit for income, war-profits, or excess-profits taxes paid other than to the United States, but subsequent to the filing of such return chooses to claim such credit, the taxpayer must so notify the Commissioner and attach to such notification Form 1116 in the case of an individual, and Form 1118 in the case of a corporation. The form must be carefully filled in with all the information there called for and with the calculations of credits there indicated, and must be duly signed and sworn to or affirmed. Except where it is established to the satisfaction of the Commissioner that it is impossible for the taxpayer to furnish such evidence, the form must have attached to it (1) the receipt for each such tax payment if credit is sought for taxes already paid

or (2) the return on which each such accrued tax was based if credit is sought for taxes accrued. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. Any additional information necessary for the determination under section 119 of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the Commissioner, be furnished by the taxpayer.

(b) Where it has been established to the satisfaction of the Commissioner that it is impossible (1) to furnish a receipt for such foreign tax payment or (2) the foreign tax return, or (3) direct evidence of the amount of tax withheld at the source, secondary evidence of the payment or accrual of the tax or of the withholding of the tax may, in his discretion, and under such rules as he may prescribe, be accepted by the Commissioner.

(c) In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual and Form 1119 by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. (See also section 1126 of the Revenue Act of 1926, as amended.)

(d) For credit where taxes are paid by a foreign corporation controlled by a domestic corporation, see § 29.131–7. A claim for credit in such a case is also to be made on Form 1118. See § 29.131–6 with reference to the option granted by section 131 (d).

(e) The taxpayer may, with respect to a particular taxable year, claim the benefits of section 131 at any time prior to the expiration of the period prescribed for the making of claim for credit or refund of the tax imposed under chapter 1 for such taxable year.

§ 29.131–4 *Redetermination of tax when credit proves incorrect.* In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such 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.

§ 29.131–5 *Countries which do or do not satisfy the similar credit requirement.* A country satisfies the similar credit requirement of section 131 (a) (3), as to income tax paid to such country, either by allowing to citizens of the United States residing in such country a credit for the amount of income taxes paid to the United States, or, in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such country. A country does not satisfy the similar credit requirement of section 131 (a) (3) if it does not allow any credit to citizens of the United States residing in such country for the amount of income taxes paid to the United States, or if such country does not impose any income taxes. If the country of which a resident alien is a citizen or subject does not allow to a United States citizen residing in such country a credit for taxes paid by such citizen to another foreign country, no credit is allowed to such resident alien for taxes paid by him to such other foreign country.

§ 29.131-6 *When credit for taxes may be taken.* (a) The credit for taxes provided by section 131 (a) may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed upon the accrual basis or upon the cash receipts and disbursements basis. Section 131 (d) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 131 (d) or under section 222 (c) or 238 (c) of the Revenue Act of 1924 or 1926, or under section 131 (d) of the Revenue Act of 1928, 1932, 1934, 1936, or 1938, must be followed in returns for all subsequent years, and no portion of any such taxes will be allowed as a deduction from gross income.

(b) If, however, under the provisions of § 29.43-1 an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 29.131-7 *Taxes of subsidiary corporation—*(a) *Domestic corporation owning a majority of the stock of a foreign corporation.* In the case of a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes not only the income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States by such domestic corporation, but also income, war-profits, and excess-profits taxes deemed to have been paid determined by taking the same proportion of any income, war-profits, and excess-profits taxes paid or accrued by such controlled foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. See, however, the limitations provided in section 131 (b) and § 29.131-8. If dividends are received from more than one controlled foreign corporation, the limitation is to be computed separately for the dividends received from each controlled foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to the taxes deemed to have been paid as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by a controlled foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only.

(b) *Foreign subsidiary of foreign subsidiary of a domestic parent corporation.* (1) In the case of any foreign corporation coming within the scope of section 131 (f) (1) and paragraph (a) of this section in which such foreign corporation (referred to in this section as the foreign parent) owns all of the stock, except qualifying shares, of another foreign corporation (referred to in this section as the foreign subsidiary), the foreign parent, receiving a dividend from the foreign subsidiary, shall be deemed to have paid that proportion of the income, war-profits, and excess-profits taxes actually paid by the foreign subsidiary upon or with respect to the accumulated profits of such foreign subsidiary which the amount of such dividends bears to the amount of such accumulated profits. Such tax is then taken into consideration in the determination of the amount of income, war-profits, and excess-profits taxes paid or deemed to have been paid by the foreign parent upon or with respect to its own accumulated profits from which dividends were paid by such foreign parent to its domestic parent corporation.

(2) The application of these principles in the determination of the amount of the foreign tax available as a basis for a credit to the domestic parent corporation may be illustrated by the following example:

Example. The A Company, a domestic corporation, owns a majority of the voting stock of the B Company, Ltd., a foreign corporation, which in turn owns all of the stock except qualifying shares of the C

Company, Ltd., another foreign corporation. The accumulated profits of the B Company amount to $200,000 (including $25,000 dividend derived from the C Company) and the foreign income tax paid by the B Company with respect to such accumulated profits amounts to $60,000. The C Company has accumulated profits of $150,000 upon or with respect to which the foreign income, war-profits, and excess-profits taxes are $45,000. A dividend of $50,000 is paid in 1942 by the B Company to the A Company and in the same year a dividend of $25,000 is paid by the C Company to the B Company. The amount of the foreign income, war-profits, and excess-profits tax of the C Company deemed to have been paid by the B Company is

$$\frac{25{,}000}{150{,}000} \times \$45{,}000, \text{ or } \$7{,}500.$$

The proportion of the foreign income tax deemed to have been paid by the A Company with respect to the accumulated profits of the B Company from which the dividend of $50,000 was paid by the B Company to the A Company equals

$$\frac{50{,}000}{200{,}000} \times (\$60{,}000 \text{ plus } \$7{,}500) \text{ equals } \$16{,}875.$$

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5452, 10 F. R. 4256]

§ 29.131–8 *Limitations on credit for foreign taxes.* (a) The amount of the income and profits taxes paid or accrued (including the taxes which, in accordance with the provisions of section 131 (f), are deemed to have been paid) during the taxable year to each foreign country or possession of the United States, limited under section 131 (b) (1) so as not to exceed that proportion of the tax against which credit is taken which the taxpayer's net income from sources within such country or possession bears to his entire net income, or, in the case of a corporation, which the taxpayer's normal-tax net income from sources within such country or possession bears to its entire normal-tax net income, for the same taxable year, is the tentative credit in respect of the taxes paid or accrued to such country or possession. The sum of these tentative credits, limited under section 131 (b) (2) so as not to exceed the same proportion of the tax against which credit is taken which the taxpayer's net income from sources without the United States bears to his entire net income, or, in the case of a corporation, which the taxpayer's normal-tax net income from sources without the United States bears to its entire normal-tax net income, for the same taxable year, is the amount allowable as a credit against the income tax under chapter 1 for income or profits taxes paid or accrued to foreign countries or possessions of the United States. In computing the tax against which the credit is taken there must, for taxable years beginning before January 1, 1943, be excluded the tax, if any, imposed by section 102, and for taxable years beginning after December 31, 1942, there must be excluded both the tax imposed by section 102 and the tax imposed by section 450.

(b) The operation of the limitations on the credit for foreign taxes paid by individuals may be illustrated by the following examples:

Example (1). In 1942, A, a citizen of the United States, had a net income for services rendered within the United States amounting to $50,000 and a net income from sources within Great Britain of $25,000. He is entitled to a personal exemption of $500. The credit for foreign taxes allowable to A in his return for the calendar year 1942 is $14,788.67, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	25,000.00
Total net income	75,000.00
United States income tax on $75,000	44,366.00
British income and profits taxes	15,200.00
Limitation on British income and profits taxes under section 131 (b) (1) and (2) to determine credit $\left(\frac{25{,}000}{75{,}000} \text{ of } \$44{,}366\right)$	14,788.67
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitations under section 131 (b) (1) and (2))	14,788.67

Example (2). If, in example (1), above, A had a net income from sources within Great Britain of $15,000 and a net income from sources within Canada of $10,000 and the income and profits taxes paid or accrued to Great Britain and Canada were $8,950 and $4,500, respectively, the credit for foreign taxes allowable to A would be $13,373.20, computed as follows:

Income from sources within the United States	$50,000.00
Income from sources within Great Britain	15,000.00
Income from sources within Canada	10,000.00
Total net income	75,000.00

United States income tax on $75,000	$44,366.00
British income and profits taxes	8,950.00
Limitation on British income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{15,000}{75,000} \text{ of } \$44,366\right)$	8,873.20
Tentative credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitation under section 131 (b) (1))	8,873.20
Canadian income and profits taxes	4,500.00
Limitation on Canadian income and profits taxes under section 131 (b) (1) to determine tentative credit $\left(\frac{10,000}{75,000} \text{ of } \$44,366\right)$	5,915.47
Tentative credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount is within the limitation under section 131 (b) (1))	4,500.00
Sum of tentative credits ($8,873.20 plus $4,500)	13,373.20
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\left(\frac{25,000}{75,000} \text{ of } \$44,366\right)$	14,788.67
Total amount of credit allowable (sum of tentative credits, since such sum is within the limitation under section 131 (b) (2))	13,373.20

(c) It is provided in section 131 (b) that in the case of a domestic corporation the amount of the credit for any taxable year with respect to the tax paid or accrued to any foreign country or possession of the United States shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's normal-tax net income from sources within such foreign country or possession of the United States bears to the entire normal-tax net income of such corporation for the same taxable year. The total amount of the credit shall not exceed the same proportion of the tax imposed by chapter 1 which the corporation's normal-tax net income from sources without the United States bears to the entire normal-tax net income for the same taxable year.

For taxable years beginning before January 1, 1946, the normal-tax net income from sources within any foreign country or possession of the United States shall be determined by deducting from net income from such country or possession of the United States the same proportion of the credit provided in section 26 (e) which the taxpayer's excess profits net income from sources within such country or possession of the United States bears to the taxpayer's entire excess profits net income. The normal-tax net income from sources without the United States shall likewise be determined by deducting from the net income from sources without the United States the same proportion of such credit as the excess profits net income from sources without the United States bears to the entire excess profits net income. For the determination of excess profits net income from a foreign country or from sources without the United States, and of the entire excess profits net income, for the purposes of the credit for foreign taxes, in the case of a corporation computing its excess profits tax under sections 721, 726, 731 or 736 (b) see 26 CFR, 1941 Supp., Supps., 35.729-4.

(d) The operation of the limitations provided in section 131 (b) on the credit for foreign taxes paid by corporations may be illustrated by the following examples:

Example (3). The following facts exist for the calendar year 1942 with respect to the A Corporation which makes its income tax returns on the calendar year basis:

Net income from all sources	$250,000.00
Less:	
Adjusted excess profits net income	75,000.00
Normal tax net income	175,000.00
Net income from foreign country X	100,000.00
Foreign tax paid on country X income	35,000.00
Total normal tax and surtax	70,000.00

Computation of foreign tax credit for purposes of normal tax and surtax:

$$\frac{\$100{,}000 \text{ minus}\left(\frac{100}{250}\times\$75{,}000\right)}{\$250{,}000 \text{ minus } \$75{,}000}\times \$70{,}000 \text{ equals } \$28{,}000.00$$

Amount allowable as a credit ---- $28,000.00

For the purpose of the computation, it is assumed that there are no adjustments to net income in determining excess profits net income.

(e) In the event that normal-tax net income is derived from more than one foreign country or possession of the United States, the limitation provided in section 131 (b) (2) shall be applied based

upon the taxpayer's normal-tax net income from sources without the United States and the entire normal-tax net income of the corporation and such limitation is in addition to the limitation provided in section 131 (b) (1).

(f) As to the allowance of credit for foreign income, war profits, or excess profits taxes against the excess profits tax imposed under chapter 2E, see section 729 and 26 CFR, 1941 Supp., Supps., 35.729-3.

Example (4). The net income for the calendar year 1942 and the income and profits taxes paid or accrued to foreign countries and possessions of the United States in the case of a domestic corporation were as follows:

Country	Net income	Loss	Income and profits taxes (paid or accrued)
United States	$157,500		
Great Britain	30,000		$17,000
Canada	20,000		5,600
Brazil	40,000		5,800
Argentine Republic	60,000		None
Mexico		$100,000	None
Puerto Rico	10,000		2,250
France (dividend)	50,000		9,000
France (branch)	20,000		6,000

Net income		$287,500.00
Less: Interest on United States obligations		25,000.00
		262,500.00
Less: Credit provided in section 26 (e) for income subject to excess profits tax		105,000.00
Normal tax net income		157,500.00
Surtax net income ($287,500 minus $105,000)		182,500.00
Total foreign net income		130,000.00
United States tax (not including tax imposed under section 102):		
Normal tax	$37,800.00	
Surtax	29,200.00	
		67,000.00

The income and losses from all foreign countries and possessions of the United States, except the dividend from sources within France, were derived from branch operations. Dividends of $50,000 were received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation. The French corporation paid to France income and profits taxes on income earned by it and in addition a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. For the purpose of simplicity it is assumed that the corporation computes its excess profits credit under section 713 and that there are no adjustments under section 711 other than that under section 711 (a) (1) (A), and that consequently the net income from the countries referred to is the same as the excess profits net income from such countries.

The computation of the credit is as follows:

Great Britain

Income and profits taxes paid or accrued $17,000.00

Limitation under section 131 (b) (1)

$$\frac{\$30{,}000 \text{ minus}\left(\frac{30{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minus } \$105{,}000}\times \$677{,}000 \quad\text{........ } 7{,}657.14$$

Tentative credit 7,657.14

Canada

Income and profits taxes paid or accrued 5,600.00

Limitation under section 131 (b) (1)

$$\frac{\$20{,}000 \text{ minus}\left(\frac{20{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minus } \$105{,}000}\times \$67{,}000 \quad\text{........ } 5{,}104.76$$

Tentative credit 5,104.76

Brazil

Income and profits taxes paid or accrued 5,800.00

Limitation under section 131 (b) (1)

$$\frac{\$40{,}000 \text{ minus}\left(\frac{40{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minues } \$105{,}000}\times \$67{,}000 \quad\text{........ } 10{,}209.52$$

Tentative credit 5,800.00

Argentine Republic

Tentative credit .... None

Mexico

Tentative credit .... None

Puerto Rico

Income and profits taxes paid or accrued		$2,250.00
Limitation under section 131 (b) (1) $\frac{\$40{,}000 \text{ minus}\left(\frac{10{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minus } \$105{,}000}\times \$67{,}000$		2,552.38
Tentative credit		2,250.00

France

Dividend tax paid at source		9,000.00
Income and profits taxes paid or accrued on branch operations		6,000.00
Income and profits taxes deemed under section 131 (f) to have been paid, computed as follows:		
Dividend received on December 31 of the taxable year	$50,000.00	
Income of French corporation earned during taxable year	200,000.00	
Income and profits taxes paid to France on $200,000	30,000.00	
Accumulated profits $200,000 minus $30,000	170.000.00	
French taxes applicable to accumulated profits distributed $\frac{50{,}000}{170{,}000}$ of $\frac{170{,}000}{200{,}000}$ of $30,000		7,500.00
Total income and profits taxes paid or accrued and deemed to have been paid to France		22,500.00
Limitation under section 131 (b) (1) $\frac{\$70{,}000 \text{ minus}\left(\frac{70{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minus } \$105{,}000}\times \$67{,}000$		17,866.66
Tentative credit		17,866.66

Sum of tentative credits

Great Britain	7,657.14
Canada	5,104.76
Brazil	5,800.00
Puerto Rico	2,250.00
France	17,866.66
	38,678.56
Limitation on sum of tentative credits under section 131 (b) (2) to determine credit $\frac{\$130{,}000 \text{ minus}\left(\frac{130{,}000}{262{,}500}\times \$105{,}000\right)}{\$262{,}500 \text{ minus } \$105{,}000}\times \$67{,}000$	33,180.94
Total amount of credit allowable (sum of tentative credits or the limitation under section 131 (b) (2), whichever is the lesser)	33,180.94

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5517, 11 F. R. 6534, T. D. 5452, 10 F. R. 4256, T. D. 5458, 10 F. R. 7335]

§ 29.131-9 *Joint return by husband and wife.* In case of a husband and wife making a joint return, the credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses, and the limitations prescribed by section 131 (b) upon such credit shall be applied with respect to the aggregate net income from sources within each such country or possession, the aggregate net income from all sources without the United States, and the aggregate net income from all sources, of the spouses.

RETURNS AND PAYMENT OF TAX

§ 29.141-1 *Consolidated income and excess profits tax returns of affiliated corporations*—(a) *In general.* Section 141 prescribes rules for the making of both consolidated income and excess profits tax returns by an affiliated group of corporations. Regulations promulgated as Part 23 and Part 35 (26 CFR, 1941 Supp., Supps.) of this chapter are applicable, respectively, to the making of consolidated income and excess profits tax returns, and to the determination, computation, assessment, collection, and adjustment of income and excess profits tax liabilities of the affiliated group and

each member thereof both during and after the period of affiliation.

(b) *Formation of and changes in affiliated group.* An affiliated group of corporations, within the meaning of section 141, is formed at the time that the common parent corporation, which is an includible corporation, becomes the owner directly of stock possessing at least 95 percent of the voting power of all classes of stock and at least 95 percent of each class of the nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends) of another includible corporation. A corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of stock possessing at least 95 percent of the voting power of all classes of its stock and at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends). A corporation ceases to be a member of such an affiliated group at the time that the members of such group cease to own directly stock possessing at least 95 percent of the voting power of all classes of its stock, or at least 95 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends).

(c) *Corporations to be included in consolidated returns.* The privilege of filing consolidated income and excess profits tax returns is extended to all includible corporations constituting an "affiliated group," as defined in section 141 (d). In case a corporation is a member of an affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for the part of the year during which it is a member of the group. However, a corporation which is not a member of such group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, shall not be considered a member of such group for consolidated income tax return purposes for such year, but shall be considered a member of such group for consolidated excess profits tax return purposes for such year. An "includible corporation" is defined by section 141 (e) to mean any corporation except:

(1) A corporation exempt under section 101 from the tax imposed by chapter 1;

(2) An insurance company subject to taxation under section 201 or 207 (except as provided in section 141 (f));

(3) A foreign corporation (except as provided in section 141 (g));

(4) A corporation entitled to the benefits of section 251, by reason of receiving a large percentage of its income from sources within possessions of the United States;

(5) A corporation organized under the China Trade Act, 1922;

(6) A regulated investment company subject to tax under Supplement Q (sections 361 and 362);

(7) With respect to taxable years beginning after December 31, 1943, a personal service corporation described in section 725 (a), or a corporation described in section 727 (e), (g), or (h) which without regard to the exception stated in the initial clause of section 727 would be exempt from the excess profits tax imposed by subchapter E of chapter 2. The corporations described in section 727 (e), (g), and (h) are personal holding companies as defined in section 501, certain domestic corporations satisfying the conditions prescribed in section 727 (g) with respect to gross income, and certain corporations subject to the provisions of Title IV of the Civil Aeronautics Act of 1938 satisfying the conditions prescribed in section 727 (h). If any corporation which would otherwise not be an includible corporation under section 141 (e) (7) has made and filed a consent for any taxable year beginning after December 31, 1943, to be treated as an includible corporation, the exception provided in section 141 (e) (7) and this subparagraph shall not be applicable to such corporation for the taxable year for which such consent is filed or for any subsequent taxable year. Such corporation filing a consent shall be deemed to be an includible corporation for all such years regardless of whether the affiliated group of which such corporation is a member during such years is the same as the affiliated group of which it was a member when the consent was filed. If such corporation is a common parent corporation, the making and filing of the consolidated income tax return shall constitute the making and filing of its consent under section 141 (e) (7). If such corporation is a subsidiary, the filing of its authorization and consent on Forms 1122 and 1122E in the manner prescribed by § 23.12 (b) of this chapter and 26 CFR, 1943 Cum.

Supp., Supps., 33.12 (b) shall constitute the making and filing of such consent. A consent to be treated as an includible corporation under section 141 (e) (7) cannot be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed.

The consolidated income tax return and the consolidated excess profits tax return must include every includible corporation which, under the provisions of section 141, is a member of the affiliated group. In no case may a consolidated return be filed by subsidiary corporations as an affiliated group unless the common parent corporation through which the subsidiaries are connected is a member of the group. For instance there will not be recognized as an affiliated group two domestic industrial corporations the common parent corporation of which is a regulated investment company subject to tax under Supplement Q. In addition, no corporation which is connected by stock ownership with an affiliated group of includible corporations through a nonincludible corporation may be included in the consolidated return of such group.

Every corporation which is a member of an affiliated group making consolidated returns under section 141 is a member of such group both for consolidated income tax and colsolidated excess profits tax return purposes, regardless of any exemption to which it might have been entitled if separate returns had been made. See sections 725 (b) and 727.

(d) *Consolidated returns of insurance companies.* An insurance company subject to tax under section 204 is an includible corportion and may be included in an affiliated group together with corporations other than insurance companies taxable under section 201 or section 207. Insurance companies subject to tax under section 201 or 207 are not includible corporations under section 141 (e) (2). Under section 141 (f), however, a domestic insurance company taxable under section 201 may be included in an affiliated group comprised solely of other domestic insurance companies taxable under section 201; it may not be included in an affiliated group with other corporations. Similarly, a domestic insurance company taxable under section 207 may be included in an affiliated group comprised solely of other domestic insurance companies taxable under section 207; it may not be included in an affiliated group with other corporations. An affiliated group of domestic insurance companies taxable under section 201, or a group of domestic insurance companies taxable under section 207, may not include a domestic insurance company taxable under section 204.

(e) *Foreign corporations which may be treated as domestic corporations.* In the case of a domestic corporation owning or controlling, directly or indirectly, the entire capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated as a domestic corporation. The option to treat such foreign corporation as a domestic corporation must be exercised at the time of making the first consolidated income and excess profits tax returns for any taxable year beginning after December 31, 1941, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation, it must be included in both the consolidated income and excess profits tax returns of the affiliated group of which it is a member for each year for which such group makes or is required to make a consolidated return.

(f) *Computation of tax.* The surtax imposed by section 15 or section 204 upon an affiliated group making a consolidated income tax return shall be increased by 2 percent of the consolidated corporation surtax net income. In case the consolidated corporation surtax net income exceeds $25,000, but not $50,000, the surtax on the first $25,000 is $3,000 instead of $2,500 as provided in section 15 (b) (2) in the case of corporations not making a consolidated return.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5401, 9 F. R. 10451, T. D. 5441, 10 F. R. 2425]

§ 29.142-1 *Fiduciary returns*—(a) *Taxable years beginning before January 1, 1944.* Every fiduciary, or at least one of joint fiduciaries, for taxable years beginning before January 1, 1944, must make a return of income:

(1) *Returns for individuals.* For the individual whose income is in his charge,

if the gross income of such individual is $500 or over, if single, or if married and not living with husband or wife for any part of the taxable year; or if such individual is married and was living with husband or wife for any part of the taxable year but not at the close of the taxable year and his gross income for the taxable year is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family); or if such individual is married and was living with husband or wife for the entire taxable year and the aggregate gross income of both husband and wife is $1,200 or over; or if such individual is married and was living with husband or wife at the close of the taxable year but not during the entire taxable year and the aggregate gross income of both husband and wife is $1,200 or over, or the aggregate gross income of both husband and wife is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) computed without regard to the status of either of them as head of a family), or

(2) *Returns for estates and trusts.* For the estate for which he acts if the gross income of such estate is $500 or over, and for the trust for which he acts if the gross income of such trust is $500 or over, or if any beneficiary of such as computed under section 162, is $100 or over, or if any beneficiary, of such estate or trust is a nonresident alien. A return shall be filed for the taxable year of an estate which is a period of less than 12 months if the gross income of the estate for such taxable year is greater than the personal exemption allowable to a single person having a similar taxable year. See §§ 29.25-7 and 29.47-1. The requirements as to the filing of a return for a trust remain the same regardless of whether the taxable year of the trust is a period of less than 12 months.

The return in subparagraph (1) of this paragraph shall be on Form 1040 or 1040A. In subparagraph (2) of this paragraph a return is required on Form 1041. If the gross income of the decedent from the beginning of the taxable year to the date of his death was equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as head of a family), the executor or administrator shall make a return for such decedent.

(b) *Taxable years beginning after December 31, 1943.* Every fiduciary, or at least one of joint fiduciaries, for taxable years beginning after December 31, 1943, must make a return of income:

(1) *Returns for individuals.* For the individual whose income is in his charge, if the gross income of such individual is $500 or over.

(2) *Returns for estates and trusts.* For the estate for which he acts if the gross income of such estate is $500 or over, and for the trust for which he acts if the gross income of such trust is $500 or over, or the net income of such trust, as computed under section 162, is $100 or over, or if any beneficiary of such estate or trust is a nonresident alien.

The return in subparagraph (1) of this paragraph shall be on Form 1040. In subparagraph (2) of this paragraph a return is required on Form 1041.

(c) *General requirements.* (1) A copy of the will or trust instrument sworn to by the fiduciary as a true and complete copy in cases in which the gross income of the estate or trust is $5,000 or over, must be filed with the fiduciary return of the estate or trust, together with a statement by the fiduciary indicating the provisions of the will or trust instrument which, in his opinion, determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively. If, however, a copy of the will or trust instrument, or statement relating to the provisions of the will or trust instrument, has once been filed, it need not again be filed if the fiduciary return contains a statement showing when and where it was filed. If the trust instrument is amended in any way after such copy has been filed, a copy of the amendment, together with a statement by the fiduciary, indicating the effect, if any, in his opinion, of such amendment on the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively, must be filed with the return for the taxable year in which the amendment was made. See § 29.142-5 for returns in cases where any beneficiary is a nonresident alien.

(2) For information returns required to be made by fiduciaries under section 147, see § 29.147-1.

(3) As to further duties and liabilities of fiduciaries, see section 312.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5373, 9 F. R. 5502, T. D. 5425, 10 F. R. 17]

§ 29.142-2 *Return by guardian or committee*—(a) *Taxable years beginning before January 1, 1944.* (1) For taxable years beginning before January 1, 1944, a fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, having a gross income equal to, or in excess of, the credit allowed such person by section 25 (b) (1) and (3) (computed without regard to the status of the minor or insane person as head of a family) must make a return for such person on Form 1040 or 1040A and pay the tax, unless in the case of a minor the minor himself makes a return or causes it to be made. (See § 29.25-3.)

(2) For the purpose of determining the liability of a fiduciary to render a return under the provisions of the preceding paragraph in cases where the minor or the incompetent is married and was living with husband or wife at the close of the taxable year, it is the aggregate gross income or the aggregate net income of both husband and wife which is controlling. (See § 29.51-1.)

(b) *Taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, a fiduciary acting as a guardian of a minor, or as the guardian or committee of an insane person, having a gross income of $500 or more, for the taxable year must make a return for such person on Form 1040, and pay the tax unless in the case of a minor the minor himself makes a return or causes it to be made. As to the use of the optional return see § 29.51-2 (b).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 18]

§ 29.142-3 *Returns in case of two trusts.* In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and for which the same trustee acts, the trustee shall make a single return on Form 1041 for all such trusts, notwithstanding that they may arise from different instruments. If, however, one person acts as trustee for trusts created by different persons for the benefit of the same beneficiary, he shall make a return on Form 1041 for each trust separately.

§ 29.142-4 *Return by receiver.* A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on Form 1040 (or, for taxable years beginning prior to January 1, 1944, Form 1040 or 1040A). When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. (See section 52.) A receiver in charge of the business of a partnership shall render a return on Form 1065. A receiver of the rents and profits appointed to hold and operate a mortgaged parcel of real estate, but not in control of all the property or business of the mortgagor, and a receiver in partition proceedings, are not required to render returns of income. In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. (See also sections 147 and 148 (a).)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 18]

§ 29.142-5 *Return for nonresident alien beneficiary*—(a) *United States business.* If a citizen or resident fiduciary has the distribution of the income of an estate or trust any beneficiary of which is a nonresident alien engaged in trade or business within the United States at any time within the taxable year, the fiduciary shall make a return on Form 1040B for such nonresident alien and pay any tax shown thereon to be due. (See sections 143 and 211.) Unless such return is a true and accurate return of the nonresident alien beneficiary's income from all sources within the United States, the benefits of the credits and deductions to which the beneficiary is entitled cannot be obtained in the return filed by the fiduciary. (See sections 215 and 251.) If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns, the fiduciary shall be relieved from the necessity of filing Form 1040B in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. If the sole beneficiary of an estate or trust is a nonresident alien engaged in trade or business within the United States at any

time within the taxable year, the fiduciary shall make a return on Form 1041, as well as on Form 1040B. If there are two or more such nonresident alien beneficiaries, the fiduciary shall render a return on Form 1041 and also a return on Form 1040B for each nonresident alien beneficiary. (See further § 29.217-1.)

(b) *No United States business.* A citizen or resident fiduciary having the distribution of the income of an estate or trust will not be required to make a return for any beneficiary of the estate or trust who is a nonresident alien not engaged in trade or business within the United States at any time within the taxable year if the entire amount of the tax on the income payable to such beneficiary has been withheld at the source (see sections 143 and 211 (a)). A citizen or resident fiduciary having the distribution of the income of an estate or trust shall make a return on Form 1040NB-a if a beneficiary has gross income for the taxable year of more than $15,400 from the sources specified in section 211 (a), regardless of the amount of tax withheld at the source. If the gross income from such sources is $15,400 or less, the return (if a return is required to be filed) for the beneficiary shall be on Form 1040NB. If a return is required to be filed for a beneficiary who is a resident of Canada, such return also shall be on Form 1040NB. If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns, the fiduciary shall be relieved from the necessity of filing a return in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. The fiduciary shall make a return on Form 1042 of the tax on the entire amount of the income payable to the beneficiary. In addition to such return or returns, the fiduciary shall make a return on Form 1041 for the estate or trust, irrespective of the number of beneficiaries.

§ 29.142-6 *Time for filing return upon death, or termination of trust.* (a) Under the provisions of section 47 (g), the return by a taxpayer which was not in existence throughout a taxable period of 12 months is a return for the fractional part of a year during which the taxpayer was in existence. If a return is required under the provisions of §§ 29.47-1 and 29.142-1 for the last taxable year of a decedent, the executor or administrator of the decedent shall file such return at the time prescribed in § 29.53-1. If a return for the last taxable year of an estate or trust is required to be filed under the provisions of § 29.142-1, such return shall be filed at the time prescribed in § 29.53-1, and the last date prescribed for such filing shall also be the due date for payment of the tax or the first installment thereof if payment is made under the provisions of section 56 (b).

(b) The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. Consequently the only return required to be filed by the ancillary representative is on Form 1041, which shall be filed with the collector for his district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary. If the ancillary representative for the estate of a nonresident alien is a citizen or resident of the United States, and the domiciliary representative is a nonresident alien, such ancillary representative is required to render the return otherwise required of the domiciliary representative.

§ 29.143-1 *Withholding tax at source*—(a) *Withholding in general.* (1) Withholding of a tax of 30 percent (27½ percent prior to October 31, 1942) is required in the case of fixed or determinable annual or periodical income paid to a nonresident alien individual, even though such individual is engaged in trade or business within the United States (or, with respect to amounts paid prior to October 31, 1942, was engaged in trade or business or had an office or place of business therein) or to a nonresident partnership, composed in whole or in part of nonresident alien individuals, except (i) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States (or, with respect to amounts paid prior to October 31, 1942, not engaged in trade or business and not having any office or place of business therein), (ii) interest upon bonds or other obligations

of a corporation containing a tax-free covenant and issued before January 1, 1934 (but see paragraph (b) of this section), (iii) dividends paid by a foreign corporation unless (*a*) such corporation is engaged in trade or business within the United States (or, with respect to amounts paid prior to October 31, 1942, was engaged in trade or business or had an office or place of business therein), and (*b*) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States, as determined under the provisions of section 119, (iv) dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China, and (v) except that such rate of 30 percent (27½ percent prior to October 31, 1942) shall be reduced, in the case of a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, to such rate, not less than 5 percent, as may be provided by treaty with such country. See subparagraph (2) of this paragraph for special rule with respect to compensation for services performed by a nonresident alien individual brought into the United States under the authority of the War Manpower Commission. Under the regulations prescribed pursuant to the tax convention and protocol between the United States and Canada, signed March 4, 1942, effective generally January 1, 1941, the rate of tax to be withheld at the source has been reduced to 15 percent in the case of residents of Canada. (See §§ 7.10 to 7.17, of this chapter.) Similarly, in accord with Article VII of the tax convention and protocol between the United States and Sweden, effective January 1, 1940, the rate of withholding shall, for a period of at least two years beginning with such date, be 10 percent with respect to dividends paid to residents of Sweden. (See §§ 7.200 to 7.218 of this chapter.) As to rates of withholding pursuant to the tax convention and protocol between the United States and the United Kingdom, see Treasury Decision 5532, approved August 23, 1946 (§§ 7.500–7.511 of this chapter). Withholding is required in the case of interest paid on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. (See §§ 29.22 (b) (4)-4 and 29.22 (b) (4)-6, relating to the taxation of such interest, and § 29.143-4, relating to ownership certificates.)

(2) On and after March 6, 1944, the rate of withholding provided with respect to compensation for services performed by a nonresident alien individual, or by a citizen of a possession of the United States not otherwise a citizen of the United States, brought into the United States under the authority of the War Manpower Commission for temporary employment essential to the war effort shall be at the reduced rate of 10 percent. In applying such reduced rate of withholding, however, to the compensation of a nonresident alien or other individual coming within the scope of this paragraph the proration of the personal exemption provided in § 29.143-3, is not applicable. The rate of 10 percent provided in this paragraph should, therefore, be applied against the gross amount of the compensation derived from labor or personal services by such an individual. The provisions of section 143 (b), as amended by section 132 of the Revenue Act of 1943, shall not be construed as cancelling or affecting any exemption from withholding in the case of any nonresident alien individual under existing law, regulations, or ruling, nor do such provisions affect the liability to tax of such a nonresident alien individual.

(3) Under the provisions of section 143 (b) the rate of tax withheld at the source shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation within the provisions of section 143 (a) (1) were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934.

(4) The tax must be withheld at the source from the gross amount of any distribution made by a corporation, other than a nontaxable distribution payable in stock or stock rights or a distribution in partial or complete liquidation, without regard to any claim that all or a portion of such distribution is not taxable. Appropriate adjustments, if any, will be made upon the filing of claims for refund.

(5) The tax need not be withheld on accrued interest paid in connection with the sale of bonds between interest dates.

(6) A tax of 30 percent (27½ percent prior to October 31, 1942) must be withheld from interest on bonds or securities

not containing a tax-free covenant, or containing a tax-free covenant and issued on or after January 1, 1934, if the owner is unknown to the withholding agent, except where such interest represents income from sources without the United States.

(7) For withholding in the case of income paid to nonresident foreign corporations, see § 29.144-1.

(8) Resident or domestic fiduciaries are required to deduct the income tax at the source from all fixed or determinable annual or periodical gains, profits, and income of nonresident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Bond interest, dividends, or other fixed or determinable annual or periodical income paid to a nonresident alien fiduciary is subject to withholding even though the beneficiaries of the estate or trust are citizens or residents of the United States.

(9) The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of section 166 or 167 is subject to withholding even though the beneficiaries of such trust are citizens or residents of the United States, and regardless of whether the beneficiaries are exempt from income tax.

(10) A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act in its behalf under the withholding provisions of the Internal Revenue Code, is required to file notice of such appointment with the Commissioner of Internal Revenue, Withholding Returns Section, Washington, D. C., giving the name and address of the agent.

(11) If, in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, or corporation, must deduct and withhold such taxes as would be required to be withheld by the assignor had not such sale or transfer been made.

(12) For determining income from sources within the United States, see section 119.

(13) As to who are nonresident alien individuals, see §§ 29.211-2 and 29.3797-8. For classification of foreign corporations, see §§ 29.231-2 and 29.3797-8. As to what partnerships are deemed to be nonresident partnerships, see § 29.3797-8.

(14) For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see §§ 29.143-3 and 29.262-4.

(b) *Tax-free covenant bonds issued before January 1, 1934.* (1) The withholding provisions of section 143 (a) (1) are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 143 (a) (1) bonds, mortgages, or deeds of trust, or other similar obligations of a corporation are issued when delivered. If a broker or other person acts as selling agent of the obligor the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

(2) In order that the date of issue of bonds, mortgages, or deeds of trust, or other similar obligations of corporations containing a tax-free covenant may be readily determined by the owner, for the purpose of preparing the ownership certificates required under §§ 29.143-1 to 29.143-9, 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.

(3) In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 143 (a) but falls within the class of interest described in section 143 (b).

(4) In the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary, or a partnership, whether resident or nonresident, withholding of a tax of 2 percent is required, except that if the liability assumed by the obligor in connection with such a covenant does not exceed 2 percent of the interest, withholding is required at

the rate of 30 percent (27½ percent prior to October 31, 1942) in the case of a nonresident alien, or a nonresident partnership composed in whole or in part of nonresident alien individuals, or if the owner is unknown to the withholding agent. The rates of withholding applicable to the interest on bonds or other obligations of a corporation containing a tax-free covenant, and issued before January 1, 1934, are applicable to interest on such obligations issued by a domestic corporation or a resident foreign corporation. However, withholding is not required in the case of interest payments on such bonds or obligations if such interest is not to be treated as income from sources within the United States under section 119 (a) (1) (B) and the payments are made to a nonresident alien or a partnership composed wholly of nonresident aliens. A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent upon the interest on its tax-free covenant bonds issued before January 1, 1934, paid to an individual or fiduciary who is a citizen or resident of the United States, or to a partnership any member of which is a citizen or resident, or to an unknown owner.

(5) For withholding in the case of interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, paid to nonresident foreign corporations, see § 29.144-1.

(6) Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified 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.

(7) In the case of corporate bonds or other obligations containing a tax-free covenant, issued before January 1, 1934, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax may nevertheless be claimed by the bondholder as a credit against the total amount of income tax due in accordance with section 143 (d). The tax withheld at the source upon tax-free covenant bond interest included in the income of an estate or trust and taxable to the beneficiaries thereof (including the grantor of a trust subject to section 166 or 167) is allowable, pro rata, as a credit against (i) the tax required to be withheld by the fiduciary from the income of nonresident alien beneficiaries and (ii) the total tax computed in the returns of the beneficiaries required to make returns. In the case, however, of corporate bonds or other obligations containing an appropriate tax-free covenant, the corporation paying for someone else, pursuant to its agreement, a State tax or any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5357, 9 F. R. 4328, T. D. 5580, 12 F. R. 7826]

§ 29.143-2 *Fixed or determinable annual or periodical income.* (a) Only fixed or determinable annual or periodical income is subject to withholding. The Internal Revenue Code specifically includes in such income, interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income are included, as, for instance, royalties.

(b) Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. The share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is distributable, whether distrib-

uted or not, or which has been paid or credited during the taxable year to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income within the meaning of section 143 (b). The income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income. Such items as taxes, interest or mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

§ 29.143-3 *Exemption from withholding.* (a) Withholding from interest on bonds or other obligations of corporations issued prior to January 1, 1934, containing a tax-free covenant, shall not be required for taxable years beginning prior to January 1, 1944, if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating:

(1) In the case of a citizen or resident of the United States, that his net income does not exceed his personal exemption and credit for dependents,

(2) In the case of an estate or trust, that the net income does not exceed the credit allowed under section 163 (a) (1); and

if such taxable year begins after December 31, 1942 and prior to January 1, 1944, that the Victory tax net income does not exceed the specific exemption of $624.

(b) For taxable years beginning after December 31, 1943 and before January 1, 1946, such withholding shall not be required if there is filed with the withholding agent when presenting interest coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating:

(1) In the case of a citizen or resident of the United States, that his net income does not exceed his normal-tax exemption; and

(2) In the case of an estate or trust, that the net income does not exceed the credit allowed in section 163 (a) (1) for the purpose of the normal tax.

(c) For taxable years beginning after December 31, 1945, such withholding shall not be required if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating:

(1) In the case of a citizen or resident of the United States, that his net income does not exceed his exemptions under section 25 (b); and

(2) In the case of an estate or trust, that the net income does not exceed the credit allowed in section 163 (a) (1). To avoid inconvenience a resident alien should file a certificate of residence on Form 1078 with withholding agents, who shall forward such certificates to the Commissioner of Internal Revenue, Withholding Returns Section, Washington 25, D. C., with a letter of transmittal.

(d) The income of domestic corporations and of resident foreign corporations is free from withholding.

(e) No withholding from dividends paid by a corporation organized under the China Trade Act, 1922, is required unless the dividends are treated as income from sources within the United States under section 119 and are distributed to:

(1) A nonresident alien other than a resident of China at the time of such distribution;

(2) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in China); or

(3) A nonresident foreign corporation (other than a corporation resident in China).

(f) The salary or other compensation for personal services of a nonresident alien individual who enters or leaves the United States at frequent intervals, shall not be subject to deduction and withholding of income tax at the source if:

(1) Such nonresident alien is a resident of Canada or Mexico, or

(2) Such nonresident alien is engaged in agricultural labor as defined in section 1426 (h) of the Internal Revenue Code.

(g) Payments made by the United States or other public or private agencies or employers to nonresident aliens brought into the United States for the purpose of the production and harvesting of agricultural commodities pursuant to Public Law 45 (78th Congress), approved April 29, 1943, shall not be sub-

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ject to deduction and withholding of income tax at the source (see section 5 (b) of such Public Law 45).

(h) The following items of fixed or determinable annual or periodical income from sources within the United States received before January 1, 1945, by a citizen of France residing in France or a corporation organized under the laws of France, or received on or after January 1, 1945, by a resident of France (whether or not such resident is a citizen of France) or by a corporation or other entity organized under the laws of France, are not subject to the withholding provisions of the Internal Revenue Code, since such income is, except in the case of citizens of the United States, exempt from Federal income tax, if received before January 1, 1945, under the provisions of the tax convention and protocol between the United States and France, signed April 27, 1932, and effective January 1, 1936 (see paragraph 108 of the Appendix to this part) or, if received on or after January 1, 1945, under the provisions of the tax convention and protocol between the United States and France, signed July 25, 1939, and effective January 1, 1945:

(1) Royalties derived as consideration for the right to use copyrights, patents, secret processes and formulas, trademarks, and other analogous rights: *Provided, however,* In the case of such royalties received on or after January 1, 1945, such resident of France, or corporation or other entity organized under the laws of France, does not have a permanent establishment within the United States.

(2) Private pensions and life annuities.

(i) The person paying such incomes shall be notified by letter from the French citizen residing in France, the individual resident of France, or the corporation or other entity organized under the laws of France, as the case may be, that the income is exempt from taxation under the provisions of the applicable convention and protocol. Such letter from a citizen of France, with respect to income received before January 1, 1945, shall contain his address and a statement that he is a citizen of France residing in France. The letter of notification from an individual resident of France shall contain his address and a statement that he is a resident of France. The letter of notification from a corporation or other entity organized under the laws of France shall contain the address of its office or place of business and a statement that it is a corporation or other entity organized under the laws of France, shall be signed by an officer of such corporation or entity, and shall set forth his official title. In the case of royalties derived on or after January 1, 1945, the letter of notification shall also state that the individual resident of France, or corporation or other entity organized under the laws of France, as the case may be, does not have a permanent establishment in the United States. The recipient of the letter of notification shall immediately forward such letter or a copy thereof to the Commissioner of Internal Revenue, Withholding Returns Section, Washington 25, D. C.

(j) As to items of income received on or after January 1, 1940, by individual residents of Sweden or by Swedish corporations or other Swedish entities and not subject to the withholding provisions of the Internal Revenue Code, see the tax convention between the United States and Sweden, effective January 1, 1940, and the regulations thereunder. (See §§ 7.200 to 7.218, of this chapter.)

(k) As to items received on or after January 1, 1941, by individual residents of Canada and not subject to the withholding provisions of the Internal Revenue Code, see the tax convention and protocol between the United States and Canada, effective January 1, 1941, and the regulations thereunder. (See §§ 7.10 to 7.17, of this chapter.)

(l) As to items of income received on or after January 1, 1945, by residents of the United Kingdom (including foreign corporations) and not subject to the withholding provisions of the Internal Revenue Code, see the tax convention and protocol between the United States and the United Kingdom and Treasury Decision 5532 (§§ 7.500–7.511 of this chapter).

(m) A nonresident alien individual not engaged in trade or business within the United States at any time within the taxable year is subject to the tax imposed by section 211 (a) on gross income and is not entitled to any personal exemption or credit for dependents for taxable years beginning before January 1, 1944, to the normal-tax exemption or the surtax exemptions for taxable years beginning after December 31, 1943, and before January 1, 1946, or to the exemptions under section 25 (b) for taxable years beginning after December 31, 1945. A nonresident

alien individual who is engaged in trade or business within the United States at any time during the taxable year is entitled to the personal exemption for taxable years beginning before January 1, 1944, and to the normal-tax exemption and the surtax exemption allowed by section 25 (b) (1) (A) for taxable years beginning after December 31, 1943, and before January 1, 1946, and to the exemption allowed by section 25 (b) (1) (A) for taxable years beginning after December 31, 1945. If such nonresident alien is a resident of Canada or Mexico, he is also entitled to the credit for dependents for taxable years beginning before January 1, 1944, and to the surtax exemptions or exemptions for both normal tax and surtax allowed by section 25 (b) (1) (B) and (C) for taxable years beginning after December 31, 1943. The benefit of such exemptions or credit for dependents may not be received by filing a claim therefor with the withholding agent. However, in the determination of the tax to be withheld at the source under section 143 (b) with respect to remuneration paid on or after July 1, 1943, for labor or personal services performed within the United States by a nonresident alien, the benefit of the personal exemption for taxable years beginning before January 1, 1944, or the normal-tax and surtax exemptions or exemption for both normal tax and surtax for taxable years beginning after December 31, 1943, shall be allowed, prorated upon the basis of $1.40 per day for the period of employment during any portion of which labor or personal services are performed within the United States by such alien. Thus if A, a nonresident alien seaman employed by the X Shipping Corporation, is paid upon the termination of the voyage and such voyage covers 100 days, and A performed personal services within the United States during, or incident to, such voyage, the amount of $140 will be allocated as the portion of the personal exemption, normal-tax and surtax exemptions, or exemption for normal tax and surtax to be allowed as a credit against the remuneration of A for personal services performed within the United States during such voyage, and withholding shall be applied against the balance, if any, of such remuneration. If, for example, the total remuneration paid to A for such voyage is $800, of which the amount of $120 is allocable to sources within the United States, there is no withholding. As to what constitutes remuneration for labor or personal services performed within the United States, see section 119 (a) (3) and § 29.119-4. The amount of the compensation allocable to labor or personal services performed within the United States together with the amount of the personal exemption, normal-tax and surtax exemptions, or exemption for both normal tax and surtax, prorated as set forth in this paragraph, shall be shown on the annual withholding return, Form 1042.

(n) Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942), annuities and pensions received by individual residents of Canada are exempt from tax and are exempt from withholding with respect to payments of such items made on or after June 27, 1942.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 18, T. D. 5443, 10 F. R. 2496, T. D. 5517, 11 F. R. 6534, T. D. 5580, 12 F. R. 7826, T. D. 5607, 13 F. R. 1454]

§ 29.143-4 *Ownership certificates for bond interest.* (a) In accordance with the provisions of section 147 (b), citizens and resident individuals and fiduciaries, resident partnerships and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates for each issue of such obligations regardless of the amount of the coupons. However, in the case of interest coupons presented on or after January 1, 1943, such ownership certificates are required to be filed by such citizens, resident, fiduciaries, and partnerships only with respect to interest coupons on bonds, mortgages, or deeds of trust, or other similar obligations issued prior to January 1, 1934, and containing a tax-free covenant. In the case of interest on obligations of the United States or any agency or instrumentality thereof, regardless of the date of issuance thereof, ownership certificates shall be filed by such citizens, residents, fiduciaries, and partnerships only in the case of interest paid prior to January 1, 1943.

(b) In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted

ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

(c) In all cases where the owner of bonds, mortgages, or deeds of trust, or other similar obligations of a corporation is a nonresident alien, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or where the owner is unknown, an ownership certificate for each issue of such obligation shall be filed when interest coupons for any amount are presented for payment. The ownership certificate is required in such cases whether or not the obligation contains a tax-free covenant. However, ownership certificates need not be filed by a nonresident alien, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation in connection with interest payments on such bonds, mortgages, or deeds of trust, or other similar obligations of a domestic or resident foreign corporation qualifying under section 119 (a) (1) (B), or of a nonresident foreign corporation. Ownership certificates (Form 1001) shall also be filed in the case of interest paid on or after January 1, 1942, on obligations of the United States or any agency or instrumentality thereof, regardless of the date of issuance of such obligations, if such obligations are owned by the persons described in the first sentence of this paragraph.

(d) The ownership certificate shall show the name and address of the obligor, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment.

(e) Ownership certificates need not be filed in the case of interest payments on obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or the obligations of possessions of the United States. (See sections 22 (b) (4).) Ownership certificates are not required to be filed in connection with interest payments on bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership. Ownership certificates are not required where the owner is a domestic corporation, a resident foreign corporation, or a foreign government.

(f) When interest coupons detached from corporate bonds, or (as to coupons presented on or after January 1, 1942) from obligations of the United States or of any agency or instrumentality thereof, are received unaccompanied by ownership certificates, unless the owner of the bonds is known to the first bank to which the coupons are presented for payment, and the bank is satisfied that the owner is a person who is not required to file an ownership certificate, the bank shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee, and alleging that the owner of the bonds is unknown to the payee. Such statement shall be forwarded to the Commissioner with the monthly (quarterly, for the calendar year 1943 and subsequent calendar years) return on Form 1012. The bank shall also require the payee to prepare a certificate on Form 1001, crossing out "owner" and inserting "payee" and entering the amount of the interest, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank.

(g) Ownership certificates are required in connection with interest payments on registered bonds as in the case of coupon bonds, except that if ownership certificates are not furnished by the owner of such bonds, ownership certificates must be prepared by the withholding agent.

§ 29.143-5 *Form of certificate for citizens or residents.* For the purpose of § 29.143-4, Form 1000 shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 should be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation.

§ 29.143-6 *Form of certificate for nonresident aliens, nonresident foreign corporations, and unknown owners.* For the purpose of § 29.143-4, Form 1001 shall be used in preparing ownership certificates (a) of nonresident aliens, (b)

of nonresident partnerships composed in whole or in part of nonresident aliens, (c) of nonresident foreign corporations, and (d) where the owner is unknown.

§ 29.143-7 *Return and payment of tax withheld.* (a) Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld from interest on bonds or other obligations of corporations and interest on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. This return should be filed with the collector for the district in which the withholding agent is located. The withholding agent shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the monthly return. Such of the forms as report interest from which the tax is to be withheld should be listed on the monthly return. While the forms reporting interest from which no tax is to be withheld need not be listed on the return, the number of such forms submitted should be entered in the space provided. However, for the calendar year 1943 and subsequent calendar years the withholding agent shall make a quarterly return on Form 1012 on or before the last day of the month following the termination of the quarter for which the return is made. The ownership certificates, Forms 1000 and 1001, must be forwarded to the Commissioner with the quarterly return. Forms 1001 should be listed on the quarterly return. While Forms 1000 need not be listed on the return, the number of such forms submitted and the total amount of interest paid and of the tax withheld on such of the forms as report interest from which the tax is to be withheld should be entered in the spaces provided. If Form 1000 is modified to show the name and address of a fiscal or paying agent in the United States (see § 29.143-5), Forms 1012 and 1013 should be likewise modified. In the case of interest on obligations of the United States or of any agency or instrumentality thereof the withholding agents shall be: (1) The Commissioner of the Public Debt for interest paid by checks issued through the Bureau of the Public Debt; (2) the Treasurer of the United States for all interest paid by him, whether by check or otherwise; and (3) each Federal reserve bank for all interest paid by it, whether by check or otherwise.

(b) Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 15 on Form 1042, showing the amount of tax required to be withheld from each nonresident alien, nonresident partnership composed in whole or in part of nonresident aliens, or nonresident foreign corporation to which income other than bond interest was paid during the previous taxable year. Form 1042 should be filed with the collector for the district in which the withholding agent is located. Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, in addition to the withholding return on Form 1042, with respect to the items of income from which a tax of only 15 percent was withheld from persons whose addresses are in Canada (5 percent in the case of dividends falling within the scope of paragraph 2 of Article XI of the convention). There shall be reported on Form 1042B not only such items of income listed on Form 1042, but also such items of interest listed on monthly returns (quarterly, for the calendar year 1943 and subsequent calendar years) on Form 1012, including items of interest where the liability for withholding is only 2 percent.

(c) In every case the tax withheld must be paid to the collector on or before June 15 of the following year. For penalties and additions to the tax attaching upon failure to make such returns or such payments, see sections 145 and 291.

(d) If a debtor corporation has designated a person to act for it as withholding agent, and such person has not withheld any tax from the income nor received any funds from the debtor corporation to pay the tax which the debtor corporation assumed in connection with its tax-free covenant bonds, such person cannot be held liable for the tax assumed by the debtor corporation merely by reason of such person's appointment as withholding agent. If a duly authorized withholding agent has become insolvent or for any other reason fails to make payment to the collector of internal revenue of money deposited with it by the debtor corporation to pay taxes, or money withheld from bondholders,

the debtor corporation is not discharged of its liability under section 143 (a) (1), since the withholding agent is merely the agent of the debtor corporation.

(e) In any case where income is payable in any medium other than money, the withholding agent shall not release the property so received until it has been placed in funds sufficient to enable it to pay over in money the tax required to be withheld with respect to such income.

§ 29.143-8 *Ownership certificates in the case of fiduciaries and joint owners.* If fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. The ownership certificate should show the name of the estate or trust, in addition to the name and address of the fiduciary. If bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners.

§ 29.143-9 *Return of income from which tax was withheld.* (a) The entire amount of the income from which the tax was withheld shall be included in gross income in the return required to be made by the recipient of the income without deduction for such payment of the tax but any tax so withheld shall be credited against the total income tax as computed in the taxpayer's return. (See, however, § 29.142-5.) If the tax is paid by the recipient of the income or by the withholding agent it shall not be recollected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

(b) Tax withheld at the source upon fixed or determinable annual or periodical income paid to nonresident alien fiduciaries is deemed to have been paid by the persons ultimately liable for the tax upon such income. Accordingly, if a person is subject to the taxes imposed by section 11, 12, 13, 14, or 15 (and, for a taxable year beginning after December 31, 1942, the victory tax imposed by section 450), upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to the income so taxed to such person shall be credited against the amount of the income tax computed upon his return, and any excess shall be credited against any income, war-profits, or excess-profits tax, or installment thereof, then due from such person, and any balance shall be refunded.

§ 29.144-1 *Withholding in the case of nonresident foreign corporations.* (a) A tax of 30 percent (27½ percent prior to October 31, 1942) is required to be withheld in the case of fixed or determinable annual or periodical income paid to a nonresident foreign corporation except (1) income from sources without the United States, including interest on deposits with persons carrying on the banking business paid to such corporation, and (2) interest upon bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, where the liability assumed by the obligor exceeds 2 percent of the interest. However, in accord with Article VII of the tax convention and protocol between the United States and Sweden, effective January 1, 1940, the rate of withholding shall, for a period of at least two years beginning with such date, be 10 percent with respect to dividends paid to a corporation or other entity created or organized under the laws of Sweden. (See §§ 7.200 to 7.218, of this chapter.) Under the regulations prescribed pursuant to the tax convention and protocol between the United States and Canada, signed March 4, 1942, and effective generally January 1, 1941, the tax to be withheld at the source has been reduced to 15 percent in the case of corporations organized under the laws of Canada. (See §§ 7.10 to 7.17, of this chapter.)

(b) Withholding is required in the case of interest paid on obligations issued by the United States or any agency or instrumentality thereof on or after March 1, 1941. (See §§ 29.22 (b) (4)-4 and 29.22 (b) (4)-6, relating to the taxation of such interest, and § 29.143-4, relating to ownership certificates.)

(c) Withholding of a tax at the rate of 2 percent is required in the case of interest paid to a nonresident foreign corporation, upon bonds or other obligations of a corporation issued prior to January 1, 1934, and containing a tax-free covenant, if the liability assumed by the obligor exceeds 2 percent of the interest and the interest is treated as income from sources within the United States.

(d) A tax of 30 percent (27½ percent prior to October 31, 1942) is required to be withheld from dividends (other than dividends distributed by a corporation organized under the China Trade Act, 1922, to a resident of China) from sources within the United States paid to a nonresident foreign corporation, except that such rate of 30 percent (27½ percent prior to October 31, 1942) shall be reduced, in the case of corporations organized under the laws of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, to such rate (not less than 5 percent) as may be provided by treaty with such country. Under the regulations prescribed pursuant to the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) the rate of tax to be withheld at the source has been reduced to 15 percent effective June 27, 1942, in the case of nonresident corporations organized under the laws of Canada. Dividends paid to such corporations and conforming to the provisions of paragraph 2 of Article XI of such convention are after such effective date subject to withholding at the reduced rate of 5 percent. See §§ 7.10 to 7.17 of this chapter, approved June 27, 1942. Dividends paid by a foreign corporation are not, however, subject to withholding unless such corporation is engaged in trade or business within the United States (or, in the case of dividends paid before October 31, 1942, if such corporation was engaged in trade or business within the United States or had an office or place of business therein) and more than 85 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 119. (See also section 143.)

(e) For withholding in the case of dividends distributed by a corporation organized under the China Trade Act, 1922, see §§ 29.143–3 and 29.262–4.

(f) Under the provisions of section 143 (b), as amended by section 108 of the Revenue Act of 1942, the rate of tax withheld at the source shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation within the provisions of section 143 (a) (1) were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934.

§ 29.144–2 *Aids to withholding agents in determining liability for withholding of tax.* (a) Since no withholding of tax on bond interest, dividends, or other income is required in the case of a resident foreign corporation (see § 29.143–3), the person paying such income should be notified by a letter from such corporation that it is not subject to the withholding provisions of the Internal Revenue Code. The letter from the corporation shall contain the address of its office or place of business in the United States and be signed by an officer of the corporation giving his official title. Such letter of notification, or copy thereof, should be immediately forwarded by the recipient to the Commissioner of Internal Revenue, Withholding Returns Section, Washington 25, D. C. The same procedure should be followed in the case of resident partnerships, composed in whole or in part of nonresident aliens, not subject to the withholding provisions of the Code except in the case of interest on tax-free convenant bonds. The letter should be signed by a member of the firm.

(b) When a payor corporation, or any other person (including a nominee), having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of a shareholder, the tax should be withheld if the shareholder's address is outside the United States. If the shareholder's address is within the United States, it may be assumed that such shareholder is a citizen or a resident thereof. Unless the name and style of the shareholder are such as to indicate clearly that he is a nonresident alien, an address in care of another person in the United States does not of itself warrant the treatment of the shareholder as a nonresident alien. If a shareholder changes his address from a place without the United States to a place within the United States, the tax should be withheld unless proof is furnished showing that he is a citizen or a resident of the United States. A person's written statement that he is a citizen, or resident of the United States, may be relied upon by the payor of income as proof that such person is a citizen or resident of the United States.

(c) The following tables of withholding rates under the Internal Revenue Code, as modified by tax conventions be-

tween the United States and other countries, have been prepared for the purpose of making a summary of such rates readily available to withholding agents:

I. FOR THE PERIOD PRIOR TO OCTOBER 31, 1942

Classes of taxpayers	Corporate bond interest			Salary or other compensation for personal services	Other fixed or determinable annual or periodical income, including dividends, from sources within the United States
	With tax-free covenant and issued before Jan. 1, 1934		Without tax-free covenant or issued on or after Jan. 1, 1934, with tax-free covenant		
	If corporation assumes over 2 percent of the tax	If corporation assumes not over 2 percent of the tax			
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
1. Citizen or resident individual, fiduciary, or partnership	2	2			
2. Nonresident, individual, fiduciary, or partnership	2	27½	27½	[1] 27½	[2] 27½
3. Domestic corporation or resident foreign corporation					
4. Nonresident foreign corporation	2	27½	27½	27½	[2] [3] 27½
5. Individual, fiduciary, or partnership, resident of Canada, and corporation organized under laws of Canada	2	15	15	15	[4] 15
6. Unknown owner	2	27½	27½		

[1] Salary or compensation for personal services rendered in the United States is not subject to withholding in the case of nonresident aliens, residents of Canada or Mexico, who enter and leave the United States at frequent intervals.
[2] In the case of a resident of Sweden or a corporation or other entity organized under the laws of Sweden the rate with respect to dividends is 10 percent for at least two years beginning January 1, 1940 (see §§ 7.200 to 7.218, inclusive, of this chapter).
[3] Interest on any noncorporate security the owner of which is unknown to the withholding agent is subject to withholding at the rate of 27½ percent.
[4] Subject to the provisions of Article XI (2) of the tax convention and protocol between the United States and Canada (see §§ 7.10 to 7.17, inclusive, of this chapter).

II. FOR THE PERIOD ON AND AFTER OCTOBER 31, 1942

Classes of taxpayers	Corporate bond interest			Salary or other compensation for personal services	Other fixed or determinable annual or periodical income, including dividends, from sources within the United States
	With tax-free covenant and issued before Jan. 1, 1934		Without tax-free covenant or issued on or after Jan. 1, 1934, with tax-free covenant		
	If corporation assumes over 2 percent of the tax	If corporation assumes not over 2 percent of the tax			
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
. Citizen or resident individual, fiduciary, or partnership	2	2			
2. Nonresident individual, fiduciary, or partnership.	2	30	30	[1] 30	[2] 30
3. Domestic corporation or resident foreign corporation					
4. Nonresident foreign corporation	2	30	30	30	[2] 30
5. Nonresident alien, fiduciary, or partnership, resident of Canada, or nonresident corporation organized under the laws of Canada	2	15	15	30	[4] 15
6. Residents (including corporations) of the United Kingdom: See Treasury Decision 5532, approved Aug. 23, 1946 (26 CFR, 1946, Supp., 7.500 to 7.511)					
7. Unknown owner	2	30	30		(3)

[1] Salary or compensation for personal services rendered in the United States is not subject to withholding in the case of nonresident aliens, residents of Canada or Mexico, who enter and leave the United States at frequent intervals.
[2] In the case of a resident of Sweden or a corporation or other entity organized under the laws of Sweden the rate with respect to dividends is 10 percent for at least two years beginning Jan. 1, 1940.
[3] Interest on any noncorporate security the owner of which is unknown to the withholding agent is subject to withholding at the rate of 30 percent.
[4] Such rate was effective June 27, 1942. In the case of dividends within the provisions of Article XI (2) of the tax convention between the United States and Canada, the rate is 5 percent.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5580, 12 F. R. 7826]

§ 29.145-1 *Penalties.* The penalties provided for in section 145 cannot be assessed but are enforceable only by suit or prosecution. For limitations on prosecutions, see section 3748. The willful failure of a taxpayer to give information required in his return as to advice or assistance rendered in the preparation of the return, and the willful failure of the person preparing a return for another to execute the sworn statement required with reference thereto, make such persons subject to the penalties imposed by section 145 (a). An individual who willfully makes and subscribes a return which he does not believe to be true and correct as to every material matter, is guilty of a felony, and, if convicted, may be fined not more than $2,000 and imprisoned not more than five years (see Criminal Code, section 125, 18 U. S. C. 231). The privilege against incrimination in the fifth amendment to the Constitution is not a defense to a charge of failure to file a return, and does not authorize a refusal to state the amount of income, though the taxpayer's income was made through crime.

§ 29.146-1 *Termination of the taxable period by Commissioner.* (a) Section 146 provides that in the case of a taxpayer who designs by immediate departure from the United States or otherwise to avoid the payment of the tax for the preceding or current taxable year, the Commissioner may upon evidence satisfactory to him, declare the taxable period for such taxpayer immediately terminated and cause to be served upon him notice and demand for immediate payment of the tax for the taxable period declared terminated, and of the tax for the preceding taxable year, or so much of such tax as is unpaid. In such a case the taxpayer is entitled to the personal exemption and credit for dependents, if otherwise allowable, but the amount allowable as personal exemption and credit for dependents (for taxable years beginning before January 1, 1944) and the amount of the normal-tax exemption and the surtax exemptions (for taxable years beginning after December 31, 1943) shall be reduced proportionately to the length of the period for which the return is made. If suit is necessary to collect a tax made due and payable by the provisions of section 146 (a) (1), the Commissioner's finding is presumptive evidence of the taxpayer's design. Section 146 (a) (2) provides for a similar termination of the taxable period of a corporation if the Commissioner finds that the collection of the tax of the corporation for the current or last preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock. Such a finding of the Commissioner is considered prima facie correct. A taxpayer who is not in default in making the returns or in paying other taxes may procure the postponement until the usual time of the payment of taxes which are or may be due pursuant to this section by depositing with the Commissioner United States bonds of a principal amount not exceeding double the amount of taxes due for the taxable period, or by furnishing such other security as may be approved by the Commissioner.

(b) Except as provided in paragraph (c) of this section an alien who intends to depart from the United States will be required to file a return of income on Form 1040C and to obtain a certificate of compliance with income tax obligations from the collector or internal revenue agent in charge. A certificate of compliance is attached to and made a part of Form 1040C. An alien, whether resident or nonresident, who intends to depart from the United States should appear before the collector or internal revenue agent in charge for the district in which he resides and satisfy all income tax obligations with respect to income received or to be received, determined as nearly as may be, up to and including the date of his intended departure. Upon payment of such obligations, or upon the furnishing of such security as may be approved by the Commissioner for the payment of such obligations, or upon satisfactory evidence that no tax is due and payable, the collector or internal revenue agent in charge will issue a certificate of compliance to the applicant. A properly executed certificate of compliance issued by the collector or internal revenue agent must be presented at the point of departure. An alien presenting himself at the point of departure without such certificate of compliance will be examined by an internal revenue officer at that point and such taxes as appear to be due and owing will be collected. Citizens of the United States or of possessions of the United States departing from the United States will not be re-

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quired to procure certificates of compliance or to present any other evidence of compliance with income tax obligations.

(c) An alien who intends to depart from the United States and whose taxable year has not been terminated by the Commissioner as provided in section 146 (a), and who is not in default in making any return, or paying income, war-profits, or excess-profits tax under any Act of Congress, may procure a certificate of compliance as provided in section 146 (e) by (1) appointing in writing on Form 934 an attorney in fact, resident in the United States, to make his income tax return or returns for the taxable year current at the time of his intended departure and for the next preceding taxable year (if not already made), (2) making on Form 1040D a return of information for his taxable year current at the time of his intended departure and a return on that form for the next preceding taxable year where the period for making the income tax return for the next preceding taxable year has not expired, and (3) either paying the estimated tax as shown on the information return (Form 1040D), which will be credited on account for the year covered by such return, or furnishing security approved by the Commissioner that he will make the required return or returns and pay the tax or taxes required to be paid. If such security is approved and accepted and such further security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes may be postponed until the expiration of the time otherwise allowed for their payment. The departing alien may furnish as security a surety bond on Form 1133 in an amount not exceeding double the amount of tax for his taxable year current at the time of his intended departure, and for the next preceding taxable year (if not already paid), conditioned upon the making of his return or returns for such year or years (if not already made), and the payment of any tax or taxes that may become payable for such year or years together with any penalty and interest that may accrue thereon, such bond to be executed by a surety or sureties approved by the Commissioner. In lieu of such surety bond, the taxpayer may furnish as security a penal bond (Form 1133), approved by the Commissioner, secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax or taxes in respect of which the bond is furnished. A form of a "certificate of compliance" is made a part of Form 1040D. Bonds complying with the provisions of this section, if properly executed and with adequate surety, are approved, and may be accepted in the name of the Commissioner, by the collector or internal revenue agent in charge by signing the Form 1133 as follows:

Commissioner of Internal Revenue.

By ------------------------------
(Collector of Internal Revenue.)

(Internal Revenue Agent in Charge.)

A corporation will not be accepted as a surety on such bond unless the corporation holds a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds. If the surety on the bond is an individual or individuals such bonds shall not be accepted until an investigation is made as to the financial and other responsibility of such surety or sureties and such investigation shows that the collection of the tax is amply secured by the bond.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 18]

RETURNS AND PAYMENT OF TAX

§ 29.147-1 *Return of information as to payments of $500.* (a) All persons making payment to another person of fixed or determinable income of $500 or more in any calendar year must render a return thereof for such year on or before February 15 of the following year, except as specified in §§ 29.147-3 to 29.147-5. A return shall be made in each case on Form 1099, accompanied by transmittal Form 1096 showing the number of returns filed, except that the return with respect to distributions to beneficiaries of a trust or of an estate shall be made on Form 1041 in lieu of Forms 1099 and 1096. Returns of information on Forms 1096, 1099, and 1099L should be filed with the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y. For place of filing Form 1041 see section 53. The street and number where the recipient of the payment lives should be stated, if possible. If no present address is available, the last known post-office address must be given. Although to make necessary a return of

information the income must be fixed or determinable, it need not be annual or periodical. (See § 29.143-2.)

(b) Sums paid in respect of life insurance, endowment, or annuity contracts which are required to be included in gross income under §§ 29.22 (b) (1)-1, 29.22 (b) (2)-1, and 29.22 (b) (2)-2 come within the meaning of the term "fixed or determinable income" and are required to be reported in returns of information as required by this section, except that payments in respect of policies surrendered before maturity and lapsed policies need not be reported.

(c) Fees for professional services paid to attorneys, physicians, and members of other professions come within the meaning of the term "fixed or determinable income" and are required to be reported in returns of information as required by this section.

(d) For the purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and which is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5313, 8 F. R. 17259]

§ 29.147-2 *Return of information as to payments to employees.* (a) The names of all employees to whom payments of $500 or more are made in any calendar year, whether such total sum is made up of wages, salaries, annuities, commissions, or compensation in any other form, must be reported. In the case of any such payments of $500 or more made during the calendar year 1945 or a subsequent calendar year, if a portion thereof constitutes wages subject to withholding under section 1622 and such portion is reported on Form W-2, the remainder of such payments must be reported on Form 1099. For example, if such payments made to an employee by his employer in 1945 amount to $600 and $400 thereof represent wages subject to withholding under section 1622, and the remaining $200 represent compensation not subject to withholding, for instance, advances or reimbursements for traveling or other expenses, or insurance premiums which in accordance with § 29.165-6 are income to the employee for the year in which the insurance is purchased, the $400 must be reported on Form W-2 and the $200 must be reported on Form 1099. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments with the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y. When both main office and branch office have adequate records, the return should be filed by the main office.

(b) For years prior to 1945, amounts distributed or made available under an employees' trust governed by the provisions of section 165 to any beneficiary, in excess of the sum of his personal exemption and the amounts paid into the fund by him, must be reported by the trustee. For the calendar year 1945 and subsequent calendar years amounts distributed or made available under an employees' trust governed by the provisions of section 165, or under an annuity plan to which § 29.22 (b) (2)-5 relates, to a beneficiary shall be reported to the extent such amounts are includible in the gross income of such beneficiary where the amounts so includible are $500 or more.

(c) In the case of payments made by the United States to persons in its service (civil, military, or naval) of wages, salaries, or compensation in any other form, the returns of information shall be made by the heads of the executive departments and other United States Government establishments.

(d) For cases where no returns of information are required, see § 29.147.3. (See also § 29.22 (a)-3.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5480, 10 F. R. 12189]

§ 29.147-3 *Cases where no return of information required.* (a) Payments of the following character, although more than $500 during a calendar year, need not be reported in returns of information on Form 1099:

(1) Payments by a broker to his customers;

(2) Payments of any type made to corporations;

(3) Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges;

(4) Payments of rent made to real estate agents (but the agent must report

payments to the landlord if the amount paid during the calendar year was $500 or more);

(5) Payments made to alien employees serving in foreign countries or payments representing earned income for services rendered without the United States made to nonresident citizens entitled to the benefits of section 116 (a);

(6) Salaries and profits paid or distributed by a partnership to the individual partners;

(7) Payment of salaries, or other compensation for personal services, aggregating less than $624 for a calendar year prior to the calendar year 1944 made to a married individual (citizen or resident);

(8) 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;

(9) Payments of income upon which income tax has been withheld at the source and reported on Forms 1012, 1013, 1042, or Forms V-1, V-2, and V-3 or Forms W-1, W-2, W-2 (Rev.) and W-3;

(10) Amounts paid by the United States to persons in its service (civil, military, or naval) as an allowance for traveling expenses, including an allowance for meals and lodgings, as, for example, a per diem allowance in lieu of subsistence, and amounts paid as reimbursements for traveling expenses;

(11) Payments on or after January 1, 1943, of interest on obligations of the United States or any agency or instrumentality thereof; and

(12) (a) Payments on or after January 1, 1943, of interest on corporate bonds, except in the case of interest on bonds, mortgages, deeds of trust, or other similar obligations issued prior to January 1, 1934, and containing a tax-free covenant.

(b) If the marital status of the payee is unknown to the payor, or if the marital status of the payee changed during the year (see § 29.25-7), or if the payee is a resident of Canada or Mexico, the payee will be considered a single person for the purpose of filing a return of information on Form 1099 with respect to payments of salaries or other compensation for personal services.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 18, T. D. 5310, 8 F. R. 16644, T. D. 5313, 8 F. R. 17259]

§ 29.147-4 *Return of information as to certain interest.* In the case of payments of interest, regardless of amount, upon bonds and similar obligations of corporations, and interest on obligations of the United States or any agency or instrumentality thereof, the ownership certificates, when duly filed, shall constitute and be treated as returns of information and in such cases no return of information on Form 1099 is required. (See § 29.143-5.) (As to the requirements of filing ownership certificates for bond interest generally in the case of a nonresident alien, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation or where the owner is unknown, and with respect only to interest on obligations containing a tax-free covenant and issued prior to January 1, 1934, in the case of a citizen or resident of the United States, a resident partnership and nonresident partnership all the members of which are citizens or residents of the United States, see § 29.143-4.)

§ 29.147-5 *Return of information as to payments to other than citizens or residents.* In the case of payments of fixed or determinable annual or periodical income to nonresident aliens (individual or fiduciary), to nonresident partnerships composed in whole or in part of nonresident aliens, or to nonresident foreign corporations (see § 29.3797-8), the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. (See sections 143 and 144.)

§ 29.147-6 *Foreign items.* The term "foreign items," as used in this subpart, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States, or any item of dividends upon the stock of such corporation.

§ 29.147-7 *Return of information as to foreign items.* In the case of foreign items, an information return on Form 1099 is required to be filed by the bank or collecting agent accepting the items for collection, if the foreign item is paid to a citizen or resident of the United States (individual or fiduciary), or a partnership any member of which is a citizen or resident, and if the amount of the foreign items paid in any taxable year to an individual, a partnership, or a fiduciary is $500 or more. Such forms

accompanied by transmittal Form 1096 should be forwarded to the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y., on or before February 15 of each year. The term "collection" includes the following: (a) The payment by the licensee of the foreign item in cash; (b) the crediting by the licensee of the account of the person presenting the foreign item; (c) the tentative crediting by the licensee of the account of the person presenting the foreign item until the amount of the foreign item is received by the licensee from abroad; and (d) the receipt of foreign items by the licensee for the purpose of transmitting them abroad for deposits. (See §§ 29.147-1 and 29.147-3.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5313, 8 F. R. 17259]

§ 29.147-8 *Information as to actual owner.* (a) When the person receiving a payment falling within the provisions of the Internal Revenue Code for information at the source is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the individual, corporation, or partnership paying the income, and in default of a compliance with such demand the payee becomes liable for the penalties provided. (See section 145.) Dividends on stock are prima facie the income of the record owner of the stock. Upon receipt of dividends by a record owner, he should execute Form 1087 to disclose the name and address of the actual owner or payee. Form 1087 should be filed with the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y., not later than February 15 of the succeeding year. Unless such a disclosure is made, the record owner will be held liable for any tax based upon such dividends. (See § 29.148-1.)

(b) The filing of Form 1087 is not required (a) if the record owner is required to file a fiduciary return on Form 1041, or a withholding return on Form 1042, disclosing the name and address of the actual owner or payee, or (b) if the actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the tax has been withheld at the source prior to receipt of the dividends by the record owner. (See § 29.143-1.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5313, 8 F. R. 17259]

§ 29.148-1 *Return of information as to payments of dividends.* (a) Section 148 provides that every corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him. In accordance with that section, returns of information in respect of dividend payments shall be rendered for each calendar year as follows:

(1) Except as provided in paragraph (b) of this section, every domestic corporation or foreign corporation engaged in business within the United States or having an office or place of business or a fiscal or paying agent in the United States, making payments of dividends and distributions (other than distributions in liquidation) to any shareholder who is an individual (citizen or resident of the United States), a resident fiduciary, or a resident partnership any member of which is a citizen or resident, amounting to $100 or more during each calendar year, shall render an information return on Forms 1096 and 1099. A separate Form 1099 must be prepared for each shareholder, upon which will be shown the name and address of the shareholder to whom such payment was made, and the amount paid. These forms, accompanied by transmittal Form 1096 showing the number of Forms 1099 filed therewith, shall be filed with the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y., on or before February 15 of the following year.

(2) The periodical distributions of earnings on running installment shares of stock paid or credited by a building and loan association to its holders of that class of stock are dividends within the meaning of section 115 (a). The sum received upon withdrawal from a building and loan association in excess of the amounts paid in on account of membership fees and stock subscriptions, consisting of accumulated profits, constitutes a dividend within the meaning of section 115 (a). As to when a stock dividend is taxable as a dividend see section 115 (f).

(b) In the case of a distribution which is made from a depletion or depreciation reserve, or which for any other reason is deemed by the corporation to be nontaxable or partly nontax-

able to its shareholders, the corporation will fill in the information on both sides of Form 1096 and forward this form, together with Forms 1099, to the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y., not later than February 1 of the following year. Upon receipt of this information the Commissioner will advise the corporation by letter as to any apparent errors made by the corporation in computing the nontaxable portion of the distribution in order that the corporation may, if time permits, furnish such advice to its shareholders before the shareholders file their income tax returns for the year in which the distribution was made.

(c) In any case in which it is impossible to file the return within the time prescribed in this section, the corporation may, upon a showing of such fact, obtain a reasonable extension of time for filing the return. The request for the extension of time must be forwarded to the Commissioner of Internal Revenue, Practice and Procedure Division, Washing, D. C., on or before the date prescribed for filing the return.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5313, 8 F. R. 17259]

§ 29.148-2 *Return of information respecting contemplated dissolution or liquidation*—(a) *Making and filing of returns.* Within 30 days after the adoption of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock, the corporation shall file with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, a correct return on Form 966, made under oath or affirmation and containing the information required by paragraph (b) of this section and by such form. A like return shall be filed by the corporation in the case of any amendment of, or supplement to, a resolution or plan for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock. A return must be filed under section 148 (d) in respect of a liquidation whether or not any part of the gain or loss to the shareholders upon the liquidation is recognized under the provisions of section 112.

(b) *Contents of return*—(1) *General.* There shall be attached to and made a part of the return required by section 148 (d) and paragraph (a) of this section a certified copy of the resolution or plan, together with any amendments thereof or supplements thereto, and such return shall in addition contain the following information:

(i) The name and address of the corporation;

(ii) The place and date of incorporation;

(iii) The date of the adoption of the resolution or plan and the dates of any amendments thereof or supplements thereto; and

(iv) The collection district in which the last income tax return of the corporation was filed and the taxable year covered thereby.

(2) *Liquidation within one calendar month of 1944.* In the event that the corporation is a domestic corporation and the plan of liquidation, adopted after February 25, 1944, provides for a distribution in complete cancellation or redemption of all the capital stock of the corporation, and for the transfer of all the property of the corporation under the liquidation entirely within some one calendar month in the calendar year 1944, and any shareholder claims the benefit of section 112 (b) (7), such return shall, in addition to the information required by paragraph (b) (1) of this section, contain the following:

(i) A statement showing the number of shares of each class of stock outstanding at the time of the adoption of the plan of liquidation, together with a description of the voting power of each such class;

(ii) A list of all the shareholders owning stock at the time of the adoption of the plan of liquidation, together with the number of shares of each class of stock owned by each shareholder, the certificate numbers thereof, and the total number of votes to which entitled on the adoption of the plan of liquidation; and

(iii) A list of all corporate shareholders as of December 10, 1943, together with the number of shares of each class of stock owned by each such shareholder, the certificate numbers thereof, the total number of votes to which entitled on the adoption of the plan of liquidation, and a statement of all changes in ownership of stock by corporate shareholders between December 10, 1943, and the date of the adoption of the plan of liquidation, both dates inclusive.

(3) *Returns in respect of amendments or supplements.* If a return in respect of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock has already been filed pursuant to section 148 (d), a return in respect of any amendment thereof or supplement thereto will be deemed sufficient if it gives the date such prior return was filed and contains a duly certified copy of such amendment or supplement and all other information required by this section and by Form 966 which was not given in such prior return. If no return was filed relative to the resolution or plan which is being amended or supplemented, the return relative to the amendment thereof or supplement thereto shall contain a duly certified copy of the resolution or plan which is being amended or supplemented, together with all amendments thereof and supplements thereto, and all other information required by this section and by Form 966.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5356, 9 F. R. 4325]

§ 29.148-3 *Return of information respecting distributions in liquidation.* (a) Unless the distribution is one in respect of which information is required to be filed pursuant to § 29.112 (b) (6)-5 (b), 29.112 (g)-6 (a), or 29.371-10, every corporation making any distribution of $500 or more during a calendar year to any shareholder in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099L, giving all the information required by such forms and by these regulations. A separate Form 1099L must be prepared for each shareholder to whom such distribution was made, showing the name and address of such shareholder, the number and class of shares owned by him in liquidation of which such distribution was made, and the total amount distributed to him on each class of stock. If the amount distributed to such shareholder on any class of stock consisted in whole or in part of property other than money, the return on such form shall in addition show the amount of money distributed, if any, and shall list separately each class of property other than money distributed, giving a description of the property in each such class and a statement of its fair market value at the time of the distribution.

(b) Such forms, accompanied by transmittal Form 1096 showing the number of Forms 1099L filed therewith, shall be filed with the Commissioner of Internal Revenue, Processing Division, 260 East 161st Street, New York 51, N. Y., 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 February 25, 1944, in accordance with which all the capital stock of the corporation is canceled or redeemed and the transfer of all the property under the liquidation occurs within some one calendar month in the calendar year 1944, and any shareholder claims the benefit of section 112 (b) (7), the return on Form 1096 shall show (1) the amount of earnings and profits of the corporation accumulated after February 28, 1913, determined as of the close of such calendar month, without diminution by reason of distributions made during such calendar month, but including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed, (2) the ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation, and (3) the date and circumstances of the acquisition by the corporation of any stock or securities distributed to shareholders in the liquidation.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5313, 8 F. R. 17259, T. D. 5356, 9 F. R. 4325]

§ 29.148-4 *Information respecting compensation of officers and employees in excess of $75,000.* (a) Every corporation subject to taxation under chapter 1 which during any taxable year has paid to any officer or employee of the corporation, salary, commission, bonus, or other compensation for personal services rendered, in an aggregate amount in excess of $75,000 (in whatever form paid), shall in respect of each such taxable year, make and file, in duplicate, a schedule on the form prescribed by the Commissioner, as a part of its income tax return, in accordance with the instructions contained in the prescribed return. Such schedule shall contain the following information: (1) Name of officer or employee, (2) amount of salary paid, (3) amount of commission paid, (4) amount of bonus paid, (5) amount of other compensation paid, and (6) total compensation paid.

(b) The term "paid" as used in this section means "paid or accrued" or "paid or incurred" which shall be construed according to the method of accounting upon the basis of which the net income of the corporation is computed.

(c) Upon receipt of the returns by the collector, the schedules will be detached and forwarded by the collector to the Commissioner of Internal Revenue, Records Division, Washington, D. C.

§ 29.150-1 *License to collect foreign items.* Banks or agents collecting foreign items, as defined in § 29.147-6, and required by § 29.147-7 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Any person holding a license under the Revenue Act of 1938 or any prior Act will not be required to renew such license.

ESTATES AND TRUSTS

§ 29.161-1 *Imposition of the tax*—(a) *Scope.* Supplement E (sections 161 to 172, inclusive) prescribes that the taxes imposed upon individuals by chapter 1 shall be applicable to the income of estates or of any kind of property held in trust. The rate of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trusts.

(1) The several classes enumerated and described in the four paragraphs of section 161 (a), and which are introduced by the word "including," do not exclude others which also may come within the general purpose of that subsection.

(2) A guardian, whether of an infant or other person, is a fiduciary (see section 3797 (a) (6), and, as such, is required to make and file the return for his ward and pay the tax, or the return may be made by the ward. (See §§ 29.51-1 and 29.142-2.) The estate of a ward is not a taxable entity, in that respect differing from the estate of a deceased person or of a trust.

(3) The provisions of sections 161, 162, and 163 (relating to estates and trusts, fiduciaries, and beneficiaries) contemplate that the corpus of the trust, of the income therefrom, is, within the meaning of the Internal Revenue Code, no longer to be regarded as that of the grantor. If, by virtue of the nature and purpose of the trust, the corpus or income therefrom remains attributable to the grantor, these provisions do not apply. Thus, the provisions of sections 166 and 167 deal with certain trusts which are excluded from the scope of sections 161, 162, and 163. Other trusts not specified in sections 166 and 167 where the income is attributable to the grantor are likewise excluded from the scope of sections 161, 162, and 163. For example, a grantor is taxable under section 22 (a) on the income of a trust if he is still in practical effect the owner of the income. See § 29.22 (a)-21. A grantor is also taxable under section 22 (a) on the income of a trust providing for the payment and application of such income in satisfaction of his legal obligations. So-called alimony trusts to which section 22 (k) or section 171 applies may be of a type to which the provisions of sections 161, 162, and 163 also apply, or of a type which is excluded from the provisions of sections 161, 162, and 163. Except to the extent that section 22 (k) or section 171 governs the taxability of amounts paid, credited, or to be distributed attributable to trust property, the treatment of such trusts under sections 161, 162, and 163 or under sections 22 (a), 166, and 167 is not affected by section 22 (k) or section 171. See section 165 as to the exemptions of employees' trusts.

(b) *Taxability of the income.* The fiduciary is required to make and file the return and pay the tax on the net income of the estate or trust except as otherwise provided in sections 22 (a), 165, 166, and 167, and §§ 29.22 (a)-21, 29.22 (a)-22, 29.166-1, 29.166-2, and 29.167-1. In determining whether there is any net income subject to tax and the amount thereof, consideration is to be given to the additional deductions authorized in section 162.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5488, 11 F. R. 67]

CROSS REFERENCE: For statement of policy regarding extent of application of Treasury Decision 5488, relating to taxability of income of certain trusts, see note to § 29.22 (a)-21.

§ 29.162-1 *Income of estates and trusts.* (a) In ascertaining the tax liability of the estate of a deceased person or of a trust, there are deductible from the gross income, subject to exceptions, the same deductions which are allowed to individual taxpayers. See generally section 23, and the provisions thereof gov-

erning the right of deduction for depreciation and depletion in the case of property held in trust. Amounts allowable under section 812 (b) as a deduction in computing the net estate of a decedent are not allowed as a deduction under section 23, except subsection (w), in computing the net income of the estate unless there is filed in duplicate with the return in which the item is claimed as a deduction a statement to the effect that the items have not been claimed or allowed as deductions from the gross estate of the decedent under section 812 (b) and a waiver of any and all right to have such item allowed at any time as a deduction under section 812 (b). For items not deductible, see section 24. Against the net income of the estate or trust there are allowable certain credits, for which see sections 25 and 163.

(b) From the gross income of the estate or trust there are also deductible (either in lieu of, or in addition to, the deductions referred to in paragraph (a) of this section) the following:

(1) Any part of the gross income of the estate or trust for its taxable year which, by the terms of the will or of the instrument creating the trust, is paid or permanently set aside during such year for the charitable, etc., uses or purposes referred to or described in section 162 (a). This deduction is in lieu of that authorized by section 23 (o) in the case of individual taxpayers.

(2) Any income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to a legatee, heir, or beneficiary, whether or not such income is actually distributed. For this purpose, it is provided in section 162 (b) that "income which is to be distributed currently" includes income of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary.

(3) Any income of the estate of a deceased person for its taxable year which is properly paid or credited during such year to a legatee or heir, and any income either of such an estate or of a trust for its taxable year which is similarly paid or credited during that year to a legatee, heir, or beneficiary if there was vested in the fiduciary a discretion either to distribute or to accumulate such income.

(c) Any income of the class described in either paragraph of this section, which is currently distributable, or paid or credited, to a guardian for his ward is likewise deductible from the gross income of the estate or trust.

(d) There is included in the income of the estate or the trust, unless it is included in the income of the grantor of the trust, or in the income of some other person granted the power exercisable solely by himself to vest the property in himself (see §§ 29.166-1, 29.166-2, 29.167-1, 29.22 (a)-21, and 29.22 (a)-22:

(1) All income thereof accumulated for the benefit of unborn or unascertained persons or persons with contingent interests,

(2) All income either accumulated or held for future distribution pursuant to the terms of the will or trust,

(3) All other income of the estate or trust for its taxable year which is not to be distributed currently to legatees or other beneficiaries (see paragraph (a) (2) of this section),

(4) All income of the estate for its taxable year not properly paid or credited during such year to a legatee or heir, and

(5) All income either of the estate or of the trust for its taxable year which is not similarly paid or credited during that year to a legatee, heir, or beneficiary in case there was vested in the fiduciary a discretion either to distribute or to accumulate such income (see paragraph (b) (3) of this section).

(e) In all such cases the tax with respect to such income included in the income of the estate or trust for its taxable year is payable by the fiduciary, except where the income is deductible by the estate or trust for such taxable year (and is includible in the income of the legatee or beneficiary).

(f) Income described in subparagraphs (1), (2), (4), and (5) of paragraph (d) may, in some cases, be deductible by the estate or trust under paragraph (b) (2) of this section. It is expressly provided in section 162 (b) that such income of the estate or trust for its taxable year which, within its taxable year, becomes payable to the legatee, heir, or beneficiary is deductible by the estate or trust. Thus, if income of a trust is to be accumulated until A, the beneficiary, reaches his twenty-first birthday, which is December 31, 1942, the income of the trust (assuming the income tax returns of the trust are made on the

calendar year basis) for the calendar year 1942 is to be deducted by the trust under section 162 (b) in computing its net income for 1942 and is to be included in the income of A for his taxable year in which December 31, 1942, falls. In the case of a similar trust, where the twenty-first birthday of B, the beneficiary, was on July 1, 1942, and the income of the trust was to be accumulated until that date and then to be distributed to B at such time as the trustee in his discretion decides, if the trustee on December 31, 1942, decides to distribute the accumulated income to B, the income becomes payable to B on December 31, 1942, whether distributed to him or not. In such a case, the extent to which such amount is considered to be payable out of income of the trust for its taxable year is determined under section 162 (d) (2) and § 29.162-2 (b).

(g) Any amount described in paragraph (b) (2) and (3) of this section as being deductible from the gross income of the estate or trust shall be included in computing the net income of the legatees, heirs, or beneficiaries, whether distributed to them or not. As to the amount of income of the estate or trust which is considered paid, credited, or to be distributed, and the time thereof, for the purposes of the deduction under paragraph (b) (2) and (3) of this section and the inclusion in income of the legatee, heir, or beneficiary, see section 162 (d) and § 29.162-2.

(h) Any income of an estate or trust for its taxable year which during that year may be used, pursuant to the terms of the will or trust instrument, in the discharge or satisfaction, in whole or in part, of a legal obligation of any person is, to the extent so used, taxable to such person as though directly distributed to him as a beneficiary, except in cases to which section 22 (k) or section 171 applies. (See §§ 29.167-1, 29.171-1, and 29.171-2.)

(i) The income of an estate of a deceased person, as dealt with in the Internal Revenue Code, is therein described as received by the estate during the period of administration or settlement thereof. The period of administration or settlement of the estate is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. If an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. No taxable income is realized from the passage of property to the executor or administrator on the death of the decedent, even though it may have appreciated in value since the decedent acquired it. But see sections 42, 43, and 44. As to the taxable gain realized, or the deductible loss sustained, upon the sale or other disposition of property by an administrator, executor, or trustee, and by a legatee, heir, or other beneficiary, see sections 111 and 112. As to capital gains and losses, see section 117. A statutory allowance paid a widow is not deductible from gross income, except to the extent that under the principles of § 29.162-2 such allowance is taxable to the widow. If real estate is sold by the devisee or heir thereof, whether before or after settlement of the estate, he is taxable individually on any profit derived.

(j) The tax upon the net income of the estate or trust shall be paid by the fiduciary (see section 161 (b)). If the tax has been properly paid on the net income of an estate or trust for a taxable year, the net income on which the tax is so paid is not, generally, in the hands of the distributee thereof (the legatee, heir, or beneficiary) taxable as income to him, but if such income becomes payable in a subsequent taxable year of the estate or trust it may be required to be included in the income of the distributee under section 162 (d) (2) or (3). See § 29.162-2 (b), (c) and (d).

(k) Liability for the payment of the tax attaches to the person of the executor or administrator up to and after his discharge if prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934. Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be re-

quired to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. (See section 311.) The same considerations apply to trusts.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5380, 9 F. R. 7044]

CROSS REFERENCE: For statement of policy regarding extent of application of Treasury Decision 5488, relating to taxability of income of certain trusts, see note to § 29.22 (a)-21.

§ 29.162-2 *Allocation of estate and trust income to legatees and beneficiaries*—(a) *Allocation among annuitants.* Section 162 (d) (1) applies to all cases in which the executor or trustee can or must (for example, by the terms of the trust instrument or will) pay the whole or any part of a gift, bequest, devise, or inheritance out of other than income, except that no income is to be allocated under it to a legatee, heir, or beneficiary of a lump sum gift, bequest, devise, or inheritance. It applies in all cases of annuities where any deficiency in the amount to be paid can be made up by a payment out of corpus of the trust. It also applies in cases where amounts are to be paid or credited at intervals and the executor or trustee has discretion whether to pay or credit such amounts out of income of corpus, regardless of the source (income or corpus) to which the executor or trustee attributes such amount. If an annuity is paid, credited, or to be distributed tax-free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be income to the annuitant under the rules of section 162 (d) to the extent such payment is treated thereunder as out of income.

(1) The method of allocating income of the estate or trust for its taxable year in cases to which section 162 (d) (1) applies is as follows: The aggregate of all amounts which can be paid, credited, or distributed out of other than income (except under a gift, bequest, devise, or inheritance not to be paid, credited, or to be distributed at intervals) is obtained. The aggregate of such amounts is considered to be paid, credited, or distributed in such cases out of income of the estate or trust for its taxable year if it does not exceed the distributable income of the estate or trust for its taxable year. If the aggregate of such amounts does exceed the distributable income of the estate or trust for its taxable year, the portion of such amount paid, credited, or to be distributed to a legatee or beneficiary is considered income of the estate or trust for its taxable year which is paid, credited, or to be distributed in an amount which bears the same ratio to the amount of all distributable income as the amount so paid, credited, or to be distributed to the legatee or beneficiary bears to the aggregate of such amounts so paid, credited, or to be distributed to such legatees or beneficiaries for the taxable year of the estate or trust. The proportion stated in the preceding sentence applies only to legatees or beneficiaries of amounts which can be paid, credited, or distributed out of other than income of the estate or trust and, in computing such proportion, the amount of any gift, bequest, devise, or inheritance not to be paid, credited, or distributed at intervals is not to be included.

(2) Section 162 (d) (1) introduces a concept of distributable income. This is defined in that section as meaning (i) the net income of the estate or trust computed with the deductions allowed under subsections (b) and (c) of section 162 in the case of amounts paid, credited, or to be distributed to which section 162 (d) (1) does not apply, or (ii) the income of the estate or trust minus the deductions provided in subsections (b) and (c) of section 162 in the case of amounts paid, credited, or to be distributed to which section 162 (d) (1) does not apply, whichever is greater. "Net income," as thus used, means the statutory net income of the trust under the Internal Revenue Code before the application of section 162 (b) and (c) (but, as stated in the preceding sentence, such amount is to be reduced by the deductions allowed under subsections (b) and (c) of section 162 in the case of amounts to which section 162 (d) (1) does not apply). "Income," as thus used, must be determined in accordance with the following principles: First, such "income" means, in general, the amount which under the applicable law of estates and trusts is considered income available for distribution to the life tenant, legatee, or beneficiary, as the case may be. Second, there must be eliminated from the income of the estate or trust, determined in accordance with the terms of the trust instrument and State law, items of income which are not includible in income of an individual for Federal income tax pur-

poses. Therefore, the "income," referred to in clause (B) of section 162 (d) (1), may exceed net income and thus be treated as distributable income under section 162 (d) in cases where items which are deductible for Federal income tax purposes are, by the terms of the trust instrument or State law, not to be used to reduce income available for distribution but to be allocated to corpus. The application of section 162 (d) (1), in general, may be illustrated by the following example:

Example. Pursuant to the terms of the will of A, a trust is established on January 1, 1942, to pay $5,000 a year to B in quarterly installments at the end of every three months, and upon the death of B to pay the corpus and any accumulated income to his estate. The returns of the trust and of B are made on the calendar year basis. The trust instrument provides that the amount payable to B is to be paid out of income (after payment of trustees' commissions) or out of corpus to the extent income is insufficient. The receipts and expenditures of the trust for 1942 are as follows:

Taxable stock dividend	$1,000
Income from rents	3,000
Tax-exempt interest from State bonds	1,000
Gain from sale of capital asset held 10 months	1,000
Deductible trustees' commissions	200
Other deductible expenditures	1,300

In accordance with the terms of the trust instrument stock dividends are to be allocated to corpus, gain from sale of a capital asset held not more than one year is to be allocated to income, and trustees' commissions are to be charged to income. However, the other expenditures indicated above ($1,300) are of a nature which under the terms of the trust instrument are to be charged to corpus. The distributable income of the trust to be deducted by it for 1942 and included in the beneficiary's income for such year is $3,300, the greater of the statutory net income and the available trust income includible in gross income, determined as follows:

Statutory Net Income (Prior to Application of Section 162 (b) and (c))

Gross income:		
Stock dividend	$1,000	
Rents	3,000	
Long-term capital gain (50 percent taken into account, section 117 (b)	500	
		$4,500
Deductions:		
Trustees' commissions	200	
Other deductible expenses	1,300	
		1,500
Net income		3,000

Trust Income Under Clause (B) of Section 162 (d) (1)

Income:		
Rents	$3,000	
Interest from State bonds	1,000	
Gain on sale of asset	1,000	
		$5,000
Expenses allocated to income:		
Trustee's commissions	200	
Eliminating items not includible in gross income:		
Tax-exempt interest	1,000	
Excluded gain on sale of asset	500	
		1,700
Income determined under section 162 (d) (1) (B)		3,300

(3) "Net income" and "income" for the purpose of section 162 (d) (1) also do not include income of a prior taxable year, even though such income may be considered income of the estate or trust for the current taxable year under section 162 (d) (2). This rule may be illustrated by the following example:

Example. Under the terms of a trust, established in 1925, the trustees are to accumulate the income thereof until A reaches his twenty-first birthday, and then are to pay A such accumulated income, and on each December 31 thereafter, are to pay B $5,000, out of income of the trust, if income is available, or, if not, out of corpus of the trust. A became 21 years of age on June 30, 1942. The returns of the trust and of A and B are made on the calendar year basis. Under section 162 (b), the income of the trust for that part of 1942 on and before June 30, 1942, is to be considered income of the trust for 1942 which is to be distributed currently to A. In computing the distributable income of the trust for 1942 which is to be considered distributed to B in payment of the $5,000 annuity, the amount of income for the first six months of 1942 which is considered to be currently distributable to A is to be deducted. Although under section 162 (d) (2) the amount of the income of the trust for the period July 1, 1941, through June 30, 1942, will be considered income of the trust for 1942 which is to be deducted by the trust and included in A's income for 1942 (see paragraph (b) and (d) of this section), for the purposes of section 162 (d) (1) such amount is not to be deducted from the trust's income for 1942 in computing its distributable income considered to be distributed to B and no account is to be taken of the income of the trust for the period July 1, 1941, through December 31, 1941.

(b) *Allocation among income beneficiaries and legatees.* Section 162 (d) (2) applies in cases where income of the estate or trust for any period becomes payable on a date more than 65 days after the beginning of its taxable year. It ap-

plies in every case where income of the estate or trust is paid, credited, or to be distributed to a legatee, heir, or beneficiary, other than a legatee, heir, or beneficiary to whom paragraph (a) of this section applies or a legatee, heir, or beneficiary of a lump sum gift, bequest, devise, or inheritance. This paragraph, and not paragraph (a) of this section, applies to income paid, credited, or to be distributed to a legatee who, in addition to any part of the principal of an estate, is entitled to receive any income during the administration of the estate or upon its termination, whether payment of such income is made in accordance with directions in the will, or for support as allowed under State law, or by the administrator to the residuary legatee in the ordinary course of administration. The rule stated in the preceding sentence, however, has no application in cases where income may be paid or credited, or is to be distributed under an obligation to pay an amount periodically at all events, whether or not income is available, as in the ordinary case of an annuity. Section 162 (d) (2) also has no application in determining the amount to be included in the income of the estate or trust under section 161 but applies only in determining the amount allowed as deductions under section 162 (b) and (c).

(1) Section 162 (d) (2) applies whether amounts are paid, credited, or to be distributed out of the income of the estate or trust for its current taxable year or out of the income for any period. It includes a rule for allocating income of the estate or trust to the legatees or beneficiaries in cases in which the income of a prior period is paid, credited, or to be distributed to the legatee or beneficiary during the taxable year of the estate or trust. In the absence of proof that any particular period of time is the source of an amount of income which becomes payable within the taxable year, the period from which such income is derived will be presumed to be a period ended with the date the income becomes payable. In such a case the year ended with the date the income becomes payable shall be considered the last 12 months of such period (whether or not other distributions under this paragraph have been made during such last 12 months) and the income which becomes payable shall be considered as derived from the most recently accumulated income for such period.

(2) As used in section 162, the term "income which becomes payable" means income to which the legatee, heir, or beneficiary has a present right, whether or not such income is actually paid. Such right may be derived from the directions in the trust instrument or will to make distributions of income at a certain date, or from the exercise of the fiduciary's discretion to distribute income, or from a recognized present right under the local law to obtain income or compel a distribution of income. Income is not considered to become payable within a taxable year where during the entire taxable year there is only a future right to such income. For example, under valid terms of a trust instrument, income received by a trust during its taxable year is to be accumulated until the twenty-first birthday of the beneficiary (or his prior death), at which time the accumulated income is to be distributed to the beneficiary (or his estate, as the case may be). In such case, the income of the trust received in any taxable year prior to the taxable year of the trust in which the date of distribution occurs (the beneficiary's twenty-first birthday or his prior death) is not income which becomes payable within such prior taxable year but is income which becomes payable in the taxable year of the trust in which the date of distribution occurs. In any case, income becomes payable at a date not later than the date it is actually paid for the use of the distributee.

(3) The application of section 162 (d) (2), in general, may be illustrated by the following examples:

Example (1). An existing trust makes its returns on the cash receipts and disbursements basis and on the basis of a calendar year accounting period. Under the terms of the trust and the local law (which allows accumulations) the income of the trust for the period of 12 months ended June 30 of each year is accumulated and the beneficiary has no right to such income until the last day of such period (June 30). For the purpose of the tax for 1941, the entire gross income received by the trust in 1941 is required to be included in its income for 1941, and, under the law applicable to 1941, the 1941 trust income distributable on June 30, 1941, is allowed as a deduction, but the 1941 trust income not distributable until June 30, 1942, is not allowable as a deduction for 1941. For the purpose of the tax for 1942, the entire gross income received by the trust in 1942 will be included in its income for 1942. Under section 162 (d) (2), the trust income for the 12 months ending June 30, 1942, which under the terms of the trust instru-

ment, is available for distribution on such date, will be considered for the purposes of section 162 (b) as income for the taxable year 1942 which becomes payable on June 30, 1942, and, accordingly, will be deducted by the trust for 1942. Assuming the beneficiary makes his income tax returns on the calendar year basis, he will include this amount deducted by the trust in 1942 in his income for 1942, unless he is permitted to exclude part or all of the income earned by the trust in the last six months of 1941 under the provisions of section 162 (d) (4). The same process will be repeated each year thereafter as long as the accounting periods and the distribution date remain the same. Thus, if, in such a case, the entire net income of the trust (determined before the application of section 162 (b)) is available for distribution and the trust receives each month $100 of such income available for distribution, for 1941 the trust will have $600 of taxable net income (before credits), that is, the excess of the $1,200 income over the $600 deduction for the June 30, 1941, distribution. For the taxable year ended December 31, 1942, the trust will include $1,200 in its income, which is its actual income for 1942 determined under section 161 without inclusion of that part of the 1941 income distributed on June 30, 1942, and without exclusion of that part of the 1942 income distributable on June 30, 1943. Assuming that the income distributable on June 30, 1942, is not to be reduced under the trust instrument and State law by the amount of tax paid by the trust with respect to the 1941 income included in such distribution, the trust will be allowed a deduction in computing its tax for 1942 of the whole $1,200 which becomes payable on June 30, 1942, and which is included in the beneficiary's income for 1942. Thus, for 1942 the trust will pay no income tax and the beneficiary will include $1,200 in computing his net income.

Example (2). An estate which came into being on January 1, 1941, accumulates the income received (as is allowed under the local law) until June 30, 1942, at which time the executor distributes $6,000 of income to the residuary legatee. The balance of the accumulated income becomes payable under the local law on December 31, 1942, the date the administration of the estate is terminated, and a final distribution of $18,000 of income is then made to the residuary legatee. It is established that the estate, which was on a cash basis, received net income, which it accumulated during the administration of the estate, at the rate of $1,000 a month, but in making the distribution to the residuary legatee the executor did not attempt to identify such distributions with the income received during any particular period during the administration of the estate. Upon such facts, for the taxable year 1942, the distribution on June 30, 1942, of $6,000 will be presumed to be a distribution out of the most recently accumulated income of the estate, that is, for the first six months of 1942, and the final distribution of $18,000 on December 31, 1942, will be considered a distribution out of the income for the entire period of administration, of which the last 12 months is the calendar year 1942 and the most recently accumulated income is the $6,000 for the last six months of 1942. Accordingly, for 1942 the estate will take a deduction of $12,000 and the legatee will include the same amount (out of the total of $24,000 received) in his income, by reason of the distributions on June 30 and December 31, 1942.

(4) The rule also applies in the case of a distribution out of income for a period which does not include any part of the current taxable year. Thus, in the case of a trust established on January 1, 1941, which accumulates the income in the first year of the trust and each year thereafter (more than 65 days after the close of the prior taxable year) distributes the prior year's accumulation, the 1941 accumulated income to be distributed in 1942 will be considered income of the trust for 1942 which is to be distributed in 1942.

(5) If the prior period, the income of which becomes payable in the taxable year, is a period of more than 12 months, then only the income of the last 12 months of such period is considered to be income which is to be distributed during the current taxable year. This rule may be illustrated by the following example:

Example. Under the terms of an existing trust with respect to which the local law allows accumulations, the trustee has discretion to either accumulate or distribute the income to the beneficiary. The income tax returns of the trust and the beneficiary are made on the calendar year basis. On April 1, 1943 the trustee distributes to the beneficiary all the income accumulated from January 1, 1940 through March 31, 1943. Pursuant to section 162 (d) (2), the amount of the income of the trust for the period April 1, 1942, through March 31, 1943, that is, for the last 12 months of the period of accumulation, is deductible under section 162 (c) in the return of the trust for the calendar year 1943, and is includible in the beneficiary's income tax return for that year. subject to the limitation provided in section 162 (d) (4). The distribution of the accumulated income will include the income of the trust for the last nine months of 1942 upon which the trust may have paid a tax for the year 1942, but such income is, if under the terms of the trust instrument and the local law the Federal income tax is a charge against such income, reduced by the amount of Federal income tax attributable to such income and paid by the trustees. If the deduction taken by the trust for the distribution to the beneficiary on April 1, 1943 exceeds the net income of the trust for

the calendar year 1943, see section 162 (d) (4) and § 29.162-2 (d).

(c) *Distributions in first 65 days of taxable year.* Section 162 (d) (3) is designed to apportion amounts paid, credited, or to be distributed within the first 65 days of the taxable year of the estate or trust to that part of such first 65 days and the preceding taxable year to which such amounts are attributable.

(1) Section 162 (d) (3) (B) applies in cases described in section 162 (d) (1), that is, generally, in cases of annuities. If an annuity becomes payable in the first 65 days of the taxable year of the estate or trust, a proportionate part of the amount which thus becomes payable is considered payable on the last day of the preceding year. This proportionate part is that part of the amount which becomes payable within the first 65 days as the part of the interval not falling within the taxable year bears to the whole period of the interval. If, however, the part of the interval not falling within the taxable year (the year in which the amount becomes payable) is a period of more than 12 months, the interval is considered to begin on a date 12 months before the end of the preceding taxable year. Thus, if $4,250 is to be paid every two years on March 1, the period of the interval ending March 1, 1943, is considered to begin 12 months preceding December 31, 1942 since the part of the interval not falling within the taxable year 1943 (March 2, 1941, through December 31, 1942) is more than 12 months. Accordingly, the interval is considered to be the period January 1, 1942, through March 1, 1943, or 425 days, and the part of the interval not falling within the taxable year is considered to be the calendar year 1942, or 365 days. Therefore, of the $4,250 which becomes payable on March 1, 1943, 365/425 of such amount, or $3,650, is considered to be an amount to be distributed on December 31, 1942. The provisions of section 162 (d) (1) determine the extent to which the amount distributed on March 1 and the amount considered to be distributed on December 31 are paid, credited, or to be distributed out of income of the estate or trust for its taxable year.

(2) Section 162 (d) (3) (A) applies in the type of cases described in section 162 (d) (2) but only where income is paid, credited, or to be distributed within the first 65 days of the taxable year of the estate or trust. In such cases, if income of the estate or trust for a period beginning before the beginning of the taxable year becomes payable within the first 65 days of the taxable year, the income for the part of such period not falling within the taxable year is considered to be paid, credited, or distributed on the last day of the preceding taxable year. If the part of such period beginning before the beginning of the taxable year is more than 12 months, only the income of the last 12 months of such part is considered paid, credited, or to be distributed on the last day of the preceding taxable year. If the amount of income for any period paid, credited, or to be distributed to a legatee or beneficiary during the taxable year of the estate or trust is less than the total amount of income (not already paid, credited, or to be distributed to legatees or beneficiaries) for such period, such amount will be considered paid, credited, or to be distributed from the most recently accumulated income of the period. For example, a trust which makes its returns on the calendar year basis and which is to distribute the income of the trust, but not in excess of $5,000, to the beneficiary each February 28 received $500 of income each month during the period March 1, 1942, through February 28, 1943, or a total of $6,000. In such case, $1,000 of the $5,000 to be distributed to the beneficiary on February 28, 1943, will be considered to be distributed out of the income of the trust for 1943 (the income of the period January 1, 1943, through February 28, 1943) and $4,000 will be considered to have been distributed to the beneficiary on December 31, 1942, out of the income of the trust for 1942.

(3) Any amount paid, credited, or to be distributed within the first 65 days of any taxable year of the estate or trust beginning after December 31, 1941, and which is allocated under section 162 (d) (3) to the last day of a taxable year beginning before January 1, 1942, is not to be reflected in the returns of the estate or trust and of the legatee or beneficiary as a deduction or as income, as the case may be, for the taxable year in which such amount is actually paid, credited, or to be distributed.

(d) *Treatment of excess deductions of estates and trusts.* Section 162 (d) (4) is designed to avoid a form of double taxation which can arise through operation of section 162 (d) (2) and (3)

(A). It becomes applicable only in cases where the deductions allowed to an estate or trust for a taxable year under section 162 (b) or (c) solely upon application of section 162 (d) (2) or (3) (A) exceed the net income of the estate or trust for such year, computed without the deductions allowed by reason of section 162 (d) (2) and (3) (A). The provisions of section 162 (d) (4) do not prevent the taxation of income distributed to legatees, heirs, or beneficiaries merely because the income may have been previously taxed to the estate or trust. See the example in paragraph (a) (2) of this section.

(1) It is in the case of an estate which terminates its administration on a date more than 65 days after the beginning of its final taxable year that section 162 (d) (4) will be applicable most frequently to eliminate the double taxation that can arise by reason of section 162 (d) (2). For example, the income of an estate during its several years of administration, amounting to $100 each month, was accumulated until the estate was closed on May 31, 1942, on which date the accumulated income was payable under the terms of the will or local law to B, the residuary legatee, together with or as a part of the residue of the estate. The return of the estate for the calendar year 1942 will include income of $500 from which there will be deducted under section 162 (c) pursuant to section 162 (d) (2) the sum of $1,200 (assuming that under the local law any income taxes paid by the estate with respect to the 1941 income are not chargeable to income). Since the estate is entitled to a deduction of $500 under section 162 (c) without the application of section 162 (d) (2), that is, for income received and distributed in the year 1942, only $700 of the $1.200 deduction is taken by the estate solely by reason of section 162 (d) (2). Thus, the deduction allowed the estate solely by reason of section 162 (d) (2) exceeds the net income of the estate for 1942 computed without such deduction by the amount of $700, which amount would be excluded from B's income for the year 1942. B's return for the calendar year 1942 would include only the income of $500 received by the estate in 1942.

(2) If a trustee is required, or permitted, under the terms of the trust to distribute in one year the income of a prior period, excess deductions of the type covered by section 162 (d) (4) also may arise by reason of section 162 (d) (2) in such a case. For example, the income of a trust for the calendar year 1942 amounted to $10,000 and was properly accumulated by the trustee until July 1, 1943, when only the income for the year 1942 was paid to the beneficiary, and no other distribution was made during the year 1943 or within the first 65 days of 1944. The net income of the trust for the year 1943, computed without the deduction allowed through the operation of section 162 (d) (2), amounted to only $8,000. The deduction of $10,000, being allowed solely by reason of section 162 (d) (2), exceeded the net income of the trust for 1943, computed without such deduction, by $2,000. Thus, section 162 (d) (4) operates so as to exclude from the beneficiary's return the amount of such excess deduction. The beneficiary, in his return for the calendar year 1943, would include $8,000 of the July 1, 1943 distribution, even though the trust may have paid taxes on such income for the year 1942.

(3) Excess deductions of an estate or trust solely by reason of section 162 (d) (3) (A) will not arise frequently, for the distribution of income within the first 65 days of a taxable year of an estate or trust will generally consist of income received by the estate or trust in the immediately preceding taxable year of the estate or trust. Thus, if on February 1, 1943 an estate or trust distributes the 1942 income to B, the deduction for such distribution is taken in the return of the estate or trust for the calendar year 1942, and in most cases the deduction allowed will be equal to the net income (before such deduction) for the year 1942. However, if the estate or trust income (as determined by the will, trust instrument, or local law) for the year 1942 payable to B on February 1, 1943 exceeded the net income of the estate or trust for 1942 before the application of section 162 (d) (3) (A), then section 162 (d) (4) would operate to exclude from B's income the amount of the excess deduction to the estate or trust. Excess deduction also can arise upon application of section 162 (d) (3) (A) in a case where a fiduciary of an estate or trust distributes within the first 65 days of its taxable year the income of a period not covering its immediately preceding taxable year. Thus if a trustee who accumulated the income for the calendar years 1941 and 1942 distributes to B on March 1, 1943 the income of the

year 1941 only, the trust in its return for the year 1942 will deduct the amount of income of the year 1941 distributed on March 1, 1943. If such deduction allowed to the trust exceeds the net income of the trust for the year 1942, computed without such deduction, B will exclude the amount of such excess from his return for the calendar year 1942.

(4) The deductions allowed to an estate or trust solely by reason of section 162 (d) (2) and (3) (A) are compared under the provisions of section 162 (d) (4) with the net income of the estate or trust computed without such deductions, except that in a case where the estate or trust in computing its net income for a taxable year is entitled to a deduction under section 162 (d) (1) (relating to amounts paid to annuitants), the amount of the deduction under section 162 (d) (1) shall be computed with the application of section 162 (d) (3) (A). Such application of section 162 (d) (3) (A) in computing the net income of an estate or trust for the purpose of section 162 (d) (4) in a case where section 162 (d) (1) is applicable is shown in the following example which also illustrates the manner in which excess deductions are treated when two or more beneficiaries are involved.

Example. Under an existing trust the trustee in his discretion may either accumulate or distribute the income to the beneficiaries, A and B, who share equally in the income of the trust. The returns of the trust and of the beneficiaries are made upon the calendar year basis. Under the terms of the trust, the trustee is required to pay an annuity of $4,000 to C on April 1 of each year. During the year 1942 the trust had gross income of $9,000 and expenses of $1,000 which were deductible in computing the net income under the Internal Revenue Code and were chargeable against income under the terms of the trust instrument.

The following distributions were made by the trustee during 1942 and the first 65 days of 1943:

$6,000 was paid to A on April 1, 1942; $5,000 as his share of the trust income during the last nine months of 1941 and $1,000 as his share of the trust income during the first three months of 1942.

$2,000 was paid to A on November 1, 1942, out of income received by the trust after March 31, 1942.

$3,000 was paid to B on January 5, 1943 out of his share of trust income for 1942.

$4,000 was paid to C, the annuitant, on April 1, 1942.

Of the $15,000 distributed, the trust is allowed deductions of only $13,000 by reason of such distributions, since only $2,000 of the $4,000 paid to C is deductible by the trust inasmuch as the distributable income as defined in section 162 (d) (1) is only $2,000, that is, $8,000 less: $1,000 of the April 1, 1942 distribution to A, the $2,000 distribution to A on November 1, 1942 and the $3,000 distribution to B on January 5, 1943.

The amount of the deductions of the trust which is to be excluded under section 162 (d) (4) in computing the net incomes of A and B is $5,000 computed as follows:

(a) Without the application of section 162 (d) (2) and (3) (A), the following deductions would not have been taken by the trust:

$5,000 paid to A on April 1, 1942 out of 1941 income, and deductible under section 162 (d) (2)	$5,000
Amount paid to B on Jan. 5, 1943, deductible for 1942 under section 162 (d) (3) (A)	3,000
Total	8,000

(b) The net income, for the purpose of section 162 (d) (4), is computed without applying section 162 (d) (2) and (3) (A), except that in computing the deduction allowed under section 162 (d) (1) it is necessary to apply section 162 (d) (3) (A) in determining the amount of the deduction allowable to the trust under section 162 (d) (1). The net income so computed is $3,000, determined as follows:

(1) Net income before any deductions under section 162	$8,000
(2) Less deductions allowable other than under section 162 (d) (2) and (3) (A):	
Paid to A on April 1, 1942 out of 1942 income	$1,000
Paid to A on November 1, 1942 out of 1942 income	2,000
Portion of the $4,000 paid to C, the annuitant (the distributable income under section 162 (d) (1) being only $2,000 in view of the $3,000 paid to B within the first 65 days of 1943)	2,000
	5,000
(3) Net income for the purpose of section 162 (d) (4)	3,000

(c) The deductions of $8,000 (from (a) above) exceed the net income of $3,000 (from (b) (3) above) by $5,000. Such excess is excluded from the net income of A and B (the beneficiaries receiving the income in (a) above) in the following proportions:

$\frac{5,000}{8,000}$ of $5,000 is excluded from A's income.

$\frac{3,000}{8,000}$ of $5,000 is excluded from B's income.

(5) Section 162 (d) (4) has no application to a case where, without applying section 162 (d) (2) or (3) (A), the deductions of the estate or trust under section 162 (b) or (c) by reason of distributions of income exceed the net income of the estate or trust for the taxable year computed under the Internal Revenue Code without such deductions. For example, section 162 (d) (4) would not be applicable in the case of a trust which receives a deduction of $10,000 by reason of its distribution to the beneficiary during the taxable year of the entire trust income (determined under the trust and local law) received during the taxable year, even though the net income of the trust under the Code before such deduction amounted to less than $10,000.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5380, 9 F. R. 7044, T. D. 5458, 10 F. R. 7335]

§ 29.163-1 *Credits to estate, trust, or beneficiary*—(a) *Personal exemption allowed estates and trusts for taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, an estate is allowed for both normal tax and surtax purposes the personal exemption allowed a single person under section 25 (b) (1). For proration of the personal exemption in the case of a taxable year of less than 12 months, see §§ 29.25-7 and 29.47-1. A trust is allowed for both normal tax and surtax purposes a credit of $100 against new income. A credit for dependents is not allowable for an estate or trust.

(b) *Exemption allowed estates and trusts for taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, and before January 1, 1946, an estate is allowed the same normal tax exemption, namely, $500, as is allowed a single person under section 25 (a) (3) and the same surtax exemption, namely, $500, as is allowed an individual under section 25 (b) (1) (A). For taxable years beginning after December 31, 1945, an estate is allowed a credit of $500 against net income for both normal tax and surtax purposes. For proration of such exemptions in the case of a fractional part of a year resulting from termination by the Commissioner under section 146 of the taxable period, see § 29.47-1. A trust is allowed for both normal tax and surtax purposes a credit of $100 against net income. A credit for dependents is not allowable to an estate or trust.

(c) *Credit for interest to estate or trust.* If no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, the estate or trust shall be allowed the credits provided in section 25 (a), in respect of interest upon certain obligations of the United States. (For reduction of credits on account of amortizable bond premium, see § 29.125-9.)

(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 net income. Any remaining portion of such interest will be allowed as a credit for the purpose of the normal tax to the estate or trust. Where the amount of the interest specified in section 25 (a) is in excess of the net income of the estate or trust, the proportionate share of such interest which each beneficiary is required to include in computing his net income and for which he is allowed a credit for normal tax purposes is an amount equal to his distributive share of the net income of the estate or trust. For taxable years beginning before January 1, 1944, each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. For taxable years beginning after December 31, 1943, no additional normal-tax exemption or surtax exemption is allowable to the beneficiary of a trust by reason of the receipt of income from such trust. (For reduction of credits on account of amortizable bond premium, see § 29.125-9.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5517, 11 F. R. 6534, T. D. 5425, 10 F. R. 19]

§ 29.165-1 *Employees' trusts*—(a) *In general.* (1) In order that a trust may be exempt under section 165 (a) it must be part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries. The trust must be formed and availed of solely to aid in the proper execution of a plan which is a definite written program and arrangement communicated to the employees, solely designed and applied to enable

such employees or their beneficiaries to share in the capital or profits of such employer's trade or business or to provide for the livelihood of such employees or their beneficiaries after the retirement of such employees.

(2) A pension plan within the meaning of section 165 (a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 165 (a), be considered a pension plan if under the plan either the benefits payable to the employee or the required contributions by the employer can be determined actuarially. A profit-sharing plan, on the other hand, is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the annual profits, (ii) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an over-all limitation, or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation of each participant. A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to that of a profit-sharing plan except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. Such a plan, with respect to determining and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, is subject to the same requirements as in the case of a profit-sharing plan. A stock bonus, pension, or profit-sharing plan, as used in section 165 (a), does not include any plan which is primarily a dismissal wage plan.

(3) The term "plan" implies a permanent as distinguished from a temporary program. While the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, if the plan is abandoned for any cause other than business necessity within a few years after it has taken effect, this will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true in the case of a pension plan under which pensions were fully funded for the highly paid employees or others in favor of whom discrimination is prohibited under section 165 (a), and which was abandoned soon after the pensions for such favored employees had been provided. The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the event a plan is abandoned, the employer should promptly notify the Commissioner, stating the circumstances which led to the discontinuance of the plan.

(4) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, even if other employees who are not shareholders are included under the plan, it will not qualify as a plan for the exclusive benefit of employees. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is

not for the exclusive benefit of employees in general if it discriminates either in eligibility requirements, contributions, or benefits by any device whatever in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 165 (a) (3), (4), and (5). Neither is a stock bonus or profit-sharing plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not so much with the form of any plan as it is with its effects in operation. For example, in section 165 (a) (5) the law specifies certain provisions, which of themselves are not discriminatory, but this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(5) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the military or naval forces. A plan covering only former employees may qualify under section 165 (a) if it complies with the provisions of section 165 (a) (3) (B), with respect to coverage, and section 165 (a) (4), with respect to contributions and benefits, as applied to all of the former employees. The term "beneficiaries" of an employee within the meaning of section 165 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plant after the death of the employee.

(6) No specific limitations are provided in section 165 (a) with respect to investments which may be made by the trustees of a trust qualifying under section 165 (a). The contributions may be used by the trustees to purchase any investments permitted by the trust agreement, to the extent allowed by local law. Where, however, the trust funds are invested in stock or securities of the employer, full disclosure must be made of the reasons for such arrangement and of the conditions under which such investments are made in order that the Commissioner may determine whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees.

(b) *Portions of years; affiliated corporations.* An exempt status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 165 (a) (6) and § 29.165-3. A trust forming part of a plan of affiliated corporations for their employees may be exempt if all the requirements are otherwise satisfied.

(c) *Proof of exemption.* (1) Every trust claiming exemption must prove its right thereto by filing with the Commissioner: (i) An affidavit showing its character, purpose, activities, sources and disposition of corpus and income, and every fact which might affect its status for exemption; (ii) verified copies of the trust instrument and of the employer's plan, showing all amendments; (iii) the latest financial statement, showing the assets, liabilities, receipts, and disbursements of the trust; and (iv) the information required under § 29.23 (p)-2 in order to show that the trust forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries, which plan meets the requirements of section 165 (a).

(2) The information required in subparagraph (1) of this paragraph must be filed for each taxable year of the trust with respect to which this section is applicable, but the documents or information mentioned in subparagraph (1) (i) and (ii) of this paragraph need not be filed with respect to other than the first of such taxable years, except when necessary to show changes occurring since the last filing: *Provided, however,* That where the information necessary to establish that the plan meets the requirements of section 165 (a) has been filed by the employer and he so notifies the trustee, the trustee, in lieu of the information required by subparagraph (1) of this paragraph, may file with the Commissioner the following information: (i) The names and addresses of the parties to the trust agreement and the date thereof; (ii) the taxable year involved;

(iii) a copy of the notification from the employer with respect to the filing of such information; (iv) the collector's office in which the employer files his returns; and (v) a request for exemption of the trust under section 165 (a).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5422, 9 F. R. 14669]

§ 29.165-2 *Impossibility of diversion under the trust instrument*—(a) *In general.* Under section 165 (a) (2) a trust is not exempt unless under the trust instrument it is impossible (in the taxable year and at any time thereafter prior to the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. As used in section 165 (a) (2), the phrase "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. It is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, but it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries. As used in section 165 (a) (2), the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of "liabilities."* The intent and purpose in section 165 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, such balance in the trust as is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous actuarial computation" is the surplus arising because actual requirements differ from the expected requirements based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding, all as made by a careful person skilled in calculating the amounts necessary to satisfy pecuniary obligations of such a nature. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial calculation. The term "liabilities" as used in section 165 (a) (2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be impossible for the employer (or other nonemployee) to recover any amounts other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all fixed and contingent obligations, and the trust instrument must contain a definite affirmative provision to that effect, whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan and whether such obligations are, technically speaking, liabilities of the em-

ployer, of the trust, or of some other person forming a part of the plan or connected with it.

§ 29.165-3 *Requirements as to coverage.* (a) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be exempt unless it is part of a plan which satisfies the coverage requirements of section 165 (a) (3). See § 26.165-5 as to the effective date of section 165 (a) (3). The percentage requirements in section 165 (a) (3) (A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the armed forces of the United States, if such employees are eligible under the plan. The application of section 165 (a) (3) (A) may be illustrated by the following example:

Example. An employer adopts a plan at a time when he has 1,000 employees. The plan provides that all full-time employees who have been in the employment for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires the participating employees to agree to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been in the employment for a period of two years. Fifty of the employees were seasonal employees whose customary employment was for not more than five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment was for not more than 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30.

Section 165 (a) (3) (A) will be met if 540 employees are covered by the plan, as shown by the following computation:

1. Total employees with respect to which the percentage requirements are applicable (1,000 minus (100 plus 50 plus 25))	825
2. Employees not eligible to participate because of age requirements	150
3. Total employees eligible to participate	675
4. Percentage of employees in item 1 eligible to participate	.81+
5. Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 165 (a) (3) (A), it may still qualify under subparagraph (B) of such section provided always that (as required by paragraphs (3) and (4) of section 165 (a)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Section 165 (a) (5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 165 (a) (3) (B) which are limited to employees who have reached a designated age or have been in the employment for a designated number of years or are employed in certain designated departments or are in other classifications: *Provided,* That the effect of covering only such employees is not to discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirement of section 165 (a) (3) (B), provided the classification as established does not discriminate in favor of shareholders, officers, employees whose principal duties consist in supervising the work of other employees, and the highly paid employees. If a contributory plan is offered to all of the employees, but the requirement of contribution by the employee participants is so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(d) Section 165 (a) (5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of subparagraph (B) merely because there are excluded from the plan employees whose annual remuneration is $3,000 or less and

as to which the Social Security Act applies. This provision, in conjunction with subparagraph (B), is intended to permit plans to qualify which supplement the social security program. A classification which excludes all employees the whole of whose remuneration constitutes wages under section 1426 (a) (1) (relating to the Federal Insurance Contributions Act), or a classification including such employees in a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from wages under such law differs from the contributions or benefits based on the employee's remuneration not so excluded, will not be a discriminatory classification merely because of such exclusion or difference. However, in making his determination with respect to discrimination in classification under section 165 (a) (3) (B) the Commissioner will consider whether the total benefits resulting to each employee under the plan and under such law or under such law only establish an integrated and correlated retirement system satisfying the tests of section 165 (a). Thus, a classification of employees under any plan which results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below such salary amount or rate may be found to be discriminatory within the meaning of subparagraph (B) unless such relative or proportionate differences in benefits as between employees resulting from such classification are approximately offset by the retirement benefits provided by the Social Security Act. For this purpose the total Social Security Act benefits of an employee, in view of the supplementary benefits provided by such law, may be considered as 150 percent of the primary insurance benefit provided thereby. A plan supplementing the Social Security Act and excluding employees earning $3,000 per annum or less will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month. Similar considerations, to the extent applicable in any case, will govern classifications under plans supplementing the benefits provided by other Federal or State laws. See section 165 (a) (5).

(e) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 165 (a) (3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 165 (a).

(f) It is provided in section 165 (a) (6) that a plan will satisfy the requirements of section 165 (a) (3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 165 (a) (3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 165 (a) (3).

§ 29.165-4 *Discrimination as to contributions or benefits.* (a) To be exempt under section 165 (a) a trust must not only meet the coverage requirements of section 165 (a) (3), but, as provided in section 165 (a) (4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan. Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see § 29.165-1 (a). Section 165 (a) (5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 165 (a) (3) or (4). (See § 29.165-3.) Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation, or to the basic or regular rate of compensation, or merely because the contributions or benefits based on the first $3,000 of annual compensation of employees subject to the Federal Insurance Contributions Act dif-

fer from the contributions or benefits based on the excess of such annual compensation over $3,000. The exceptions specified in section 165 (a) (5) are not an exclusive enumeration, but a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits. Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of a distribution formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes employees, the whole of whose remuneration constitutes wages under section 1426 (a) (1), (relating to the Federal Insurance Contributions Act), or a plan in which the contributions or benefits based on that part of an employee's remuneration which is excluded from wages under such law differs from contributions or benefits based on the employee's remuneration not so excluded, or a plan in which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 165 (a).

(c) Although a plan may provide for termination at will by the employer, this will not of itself prevent a trust from qualifying as exempt under section 165 (a). However, in certain cases that fact may necessitate some provision in the plan which will preclude such termination from effecting the prohibited discriminations. This may occur where, for example, certain officers or highly compensated employees are at the inception of the plan within a few years of retirement age and the operation of the plan will fund and vest their benefits in a short period, thus resulting in such discrimination in favor of such officers or highly compensated employees.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5422, 9 F. R. 14669]

§ 29.165-5 *Effect of amendments to section 165 (a) on old and new stock bonus, pension, profit-sharing, and annuity plans.* (a) Section 162 (d) of the Revenue Act of 1942 (set forth immediately preceding § 29.165-1) makes the requirements of section 165 (a) (3), (4), (5), and (6) inapplicable for taxable years beginning prior to January 1, 1943, in the case of a stock bonus, pension, profit-sharing, or annuity plan in effect on or before September 1, 1942. In such cases, for such taxable years a trust will be exempt if it complies with section 165 (a) (1) and (2), except that for taxable years beginning prior to January 1, 1940, it need not comply with section 165 (a) (2). The provisions of 26 CFR, 1938 ed., Supps., 19.165-1 (Regulations 103) are applicable in such a case to a taxable year beginning after December 31, 1941, and prior to January 1, 1943. A plan which requires the use of a trust is not in effect as of September 1, 1942, if there was no valid trust in existence at that time. A plan requiring the purchase of an annuity or insurance contract or contracts is not in effect as of September 1, 1942, if there is no such contract or contracts in effect at that time.

(b) In the case of a plan in effect on or before September 1, 1942, the plan will be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the beginning of the first taxable year following December 31, 1942, and ending June 30, 1945, if the provisions of the plan satisfy such requirements by June 30, 1945, and if by that time all provisions of such plan which are necessary to satisfy such requirements are in effect and have been made effective for all purposes with respect to the portion of such period after December 31, 1943. Thus, if an employer having such a plan in effect makes a return on the basis of the calendar year, he will have until June 30, 1945, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4), (5), and (6) for the calendar years 1943 and 1944 provided that by June 30, 1945, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1944. If the employer is on a fiscal year basis, for example February 1 to January 31, he will have until June 30, 1945, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4),

(5), and (6) for the fiscal years beginning February 1, 1943, and ending January 31, 1944, and beginning February 1, 1944, and ending January 31, 1945, provided that by June 30, 1945, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1944.

(c) In the case of a plan put into effect after September 1, 1942, and prior to January 1, 1945, the plan will be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with June 30, 1945, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the portion of such period after December 31, 1943. Thus, if an employer in 1943 adopts such a plan effective as of January 1, 1943, and makes a return on the basis of the calendar year he will have until June 30, 1945, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4), (5), and (6) for the calendar years 1943 and 1944, provided that by June 30, 1945, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1944. If the employer is on a fiscal year basis, for example, July 1 to June 30, and in 1943 adopts such a plan effective as of July 1, 1943, he will have until June 30, 1945, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4), (5), and (6) for the fiscal years beginning July 1, 1943, and ending June 30, 1944, and beginning July 1, 1944, and ending June 30, 1945: *Provided*, That by June 30, 1945, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1944.

(d) In the case of a plan put into effect after December 31, 1944, the plan will be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus if an employer in 1945 adopts such a plan effective as of January 1, 1945, and makes a return on the basis of the calendar year, he will have until March 15, 1946, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4), (5), and (6) for the calendar year 1945: *Provided*, That by March 15, 1945, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1945, the effective date of the plan. If an employer is on a fiscal year basis, for example April 1 to March 31, and in 1945 adopts such a plan effective as of April 1, 1945, he will have until June 15, 1946, to amend his plan so as to make it satisfy the requirements of section 165 (a) (3), (4), (5), and (6) for the fiscal year beginning April 1, 1945, and ending March 31, 1946: *Provided*, That by June 15, 1946, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1945, the effective date of the plan.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5436, 10 F. R. 1474]

§ 29.165-6 *Taxability of beneficiary under a trust which meets the requirements of section 165 (a)*. (a) Section 165 (b) and (c) relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 165 (a), the employee is not required to include such contributions in his income except in the year or years in which such contributions are distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter. The distribution from such an exempt trust when received or made available will be taxable to him as if it were an annuity to the extent provided in section 22 (b) (2). The provisions of section 165 (b) relate only to distributions by a trust which is exempt under section 165 (a) for the taxable

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year of the trust in which the distribution is made. If a trust is exempt for the taxable year in which the distribution occurs but was not so exempt for one or more prior taxable years, the amount of any such taxable distribution may be reduced by the part thereof shown to the satisfaction of the Commissioner to be properly allocated to employer's contributions or earnings of the trust previously accounted for as taxable income by the employee or to earnings of the trust previously accounted for as taxable income by the trust. Where the distribution occurs in a taxable year of the trust for which it is not exempt under section 165 (a), the taxability of such distribution will depend on the taxable status of the trust under other provisions of the Internal Revenue Code at the time of the distribution. If such trust was not exempt for one or more prior taxable years, the adjustments outlined above may be made in connection with any distribution.

(b) If a trust exempt under section 165 (a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered.

(c) If pension or annuity payments are continued after the death of a retired employee to his beneficiary, such beneficiary will be required to include such pension or annuity payments in income to the same extent that the deceased employee would have been required to include such payments in income had he lived to receive such payments. See also section 126 (a). If the trust purchases under the plan retirement income insurance with life insurance protection payable upon the death of the employee participants, so much of the premiums as was paid from the contributions of the employer or earnings thereon for such life insurance protection will constitute income to the employee for the year or years in which the contributions or earnings are applied to the purchase of such life insurance. If the amount payable upon death at any time during the year exceeds the cash value (or if no cash value, then the reserve) of the insurance policy at the end of the year, the entire amount of such excess will be considered current life insurance protection. The cost of such insurance will be considered to be the 1-year term premium for such amount based upon the rates of the company issuing the annuity contract (or if no 1-year term policy is issued, the cost of such 1-year term computed by using the same mortality table and rate of interest and rate of loading as was used in determining the rates for the annuity contract). The determination of the cost of life insurance protection may be illustrated by the following example:

Example: A policy is purchased by an employer for an employee 35 years of age, providing an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The level annual premium for the policy is $436.40. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the 1-year term premium for the same insurance company is $12.15 per $1,000, the premium for $10,000 of life insurance is therefore $121.50, and this is the amount to be reported as income by the employee for the year. The balance of $314.90 is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 165 (a), except as provided under section 165 (b). Assuming that the cash value at the end of the second year is $480, the net insurance would then be $9,520 for the second year. With a 1-year term rate of $12.33 (age 36), the amount to be reported as income to the employee would be $117.38. Any amounts paid under an annuity contract as a death benefit, not in the nature of life insurance, shall be included in the income of the beneficiary when received, and is not excluded from income under section 22 (b) (1).

(d) If the total distributions payable with respect to any employee under a trust that in the year of distribution is exempt under section 165 (a) are paid to the distributee within one taxable year of the distributee on account of the employee's separation from the service, the amount of such distribution, to the extent it exceeds the amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. For example, if, under a profit-sharing trust, the total distributions to which an employee is entitled are paid in a taxable year of the trust for which it is exempt to the employee in the year in which he retires or severs his connection with his employer, or to his widow if he dies during the course of his employment, the

amount received by the employee or widow to the extent it exceeds the employee's contributions will be considered a gain from the sale or exchange of a capital asset held for more than six months, to be taken into account to the extent provided in section 117 (b). As to adjustments if the trust was not exempt for one or more taxable years prior to the year of distribution, see paragraph (a) of this section.

§ 29.165-7 *Treatment of beneficiary of a trust not exempt under section 165 (a)*. Any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 165 (a), shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 165 (c) and 23 (p) (1) (D) at the time the contribution is made if there is no contingency under the plan which may cause the employee to lose his rights in the contribution. For example, if under the terms of a pension plan, an employee upon termination of his services prior to the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is obligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable. On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from, or to be provided by, contributions made by the employer if his services should be terminated prior to retirement, his beneficial interest in such contributions is forfeitable. The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provided only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5600, 13 F. R. 577]

§ 29.166-1 *Trusts with respect to the corpus of which the grantor is regarded as remaining in substance the owner; taxable years beginning prior to January 1, 1946.*—(a) *Scope.* If the grantor of a trust is regarded, within the meaning of the Internal Revenue Code, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor, except as provided in sections 22 (k) and 171. This section deals with the taxation of such income. As used in this section, the term "corpus" means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(b) *Test of taxability to grantor.* (1) Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this section the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor (except as provided in section 22 (k) or 171) regardless of:

(i) Whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend, or to appoint;

(ii) Whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(iii) The time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(iv) Whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both;

(v) When the trust was created.

(2) But the provisions of section 166 are not to be regarded as excluding from taxation to the grantor the income or other trusts, not specified therein, in which the grantor is, for the purposes of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

(3) In determining whether the grantor is in substance the owner of the corpus, the Internal Revenue Code has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: The fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstance bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

(4) Thus, the grantor is regarded as being in substance the owner of the corpus if, in any case, the trust amounts to no more than an arrangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of certain of his property to a trustee, the income from such property to be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust, an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

Example. A grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John.

(A) For the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) For the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) For the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

(5) If, however, the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the owner of the corpus,

the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162, and 163.

(6) A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) *Income and deductions.* If the grantor is regarded as remaining in substance the owner of the corpus, except as provided in sections 22 (k), 23 (u), and 171, the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5488, 11 F. R. 67]

CROSS REFERENCE: For statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts, see note to § 29.22 (a)-21.

§ 29.166-2 *Trusts with power to revest corpus in the grantor; taxable years beginning after December 31, 1945*—(a) *Scope.* (1) Where the power to revest in the grantor title to any part of the corpus of a trust is vested in the grantor or in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or both, the income of that part of the corpus subject to the power to revest is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor, except as provided in sections 22 (k) and 171. This section deals with the taxation of such income. As used in this section the term "corpus" means any part or the whole of the property, real or personal, constituting the subject-matter of the trust.

(2) For rules applicable to trusts the income of which is taxable to the grantor under section 22 (a) because the grantor has retained a control of the trust so complete that he is still in practical effect the owner of its income, see § 29.22 (a)-21.

(3) For rules applicable to trusts the income of which is taxable under section 22 (a) to a person other than the grantor because of a power, exercisable solely by such other person, to vest the property or the income therefrom in himself, see § 29.22 (a)-22.

(b) *Test of taxability to grantor.* (1) Section 166 provides for taxability of income to the grantor by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this section the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor (except as provided in section 22 (k) or 171) regardless of:

(i) Whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend, or to appoint;

(ii) Whether the exercise of such power is conditioned on the precedent giving of notice or on the elapsing of a period of years, or on the happening of a specific event;

(iii) The time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(iv) Whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both;

(v) When the trust was created.

(2) A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) *Income and deductions.* If income from the corpus of a trust is included in the gross income of the grantor

under this section because of a power to revest such corpus in the grantor, he shall be allowed those deductions with respect to such corpus as he would have been entitled to had the trust not been created.

[T. D. 5488, 11 F. R. 67]

CROSS REFERENCE: For statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts see note to § 29.22 (a)-21.

§ 29.167-1 *Trusts in the income of which the grantor retains an interest*—(a) *Scope.* Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the corpus of the trust (as in section 166), but because of his retention of a certain interest in the income of the trust. This section deals with the taxation of such income. The term "income", as used in this section, means any part of the whole of the income of the trust.

(b) *Test of taxability to the grantor.* (1) The test prescribed by the Internal Revenue Code as to the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether he has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him, either actually or constructively. Such a distribution to the grantor occurs within the meaning of section 167 if the income is paid to him or to another (except a wife to whom such income is taxable under section 22 (k) or 171) in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

(2) For the purposes of this section, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right so to effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse.

(3) If the grantor has retained any such interest in the income, such income is taxable to the grantor (except as provided in section 22 (k), 167 (c), or 171) regardless of:

(i) Whether it may be distributed currently or accumulated for future distribution;

(ii) Whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(iii) Whether, if such distribution is in any way affected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both;

(iv) The time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(v) When the trust was created.

(4) Thus, the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purpose of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the trust income. See § 29.22 (a)-21.

(5) If the grantor strips himself permanently and definitely of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor but is taxable as provided in sections 161 and 162.

(6) A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the income. There is to be excluded in computing the net income of the grantor only that part of the trust income in the disposition of which such person has a substantial interest adverse to the grantor.

(c) *Income and deductions.* If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income

as he would have been entitled to had such income been distributable currently to him.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5392, 9 F. R. 8008, T. D. 5488, 11 F. R. 68.]

CROSS REFERENCE: For statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts, see note to § 29.22 (a)-21.

§ 29.167-2 *Discretionary trusts for maintenance or support of certain beneficiaries.* (a) Section 167 (c) provides that income shall not be taxable to the grantor under section 167 (a) or any other provision of chapter 1 of the Internal Revenue Code merely because such income, in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee, may be applied or distributed for the support or maintenance of a beneficiary, such as the wife or child of the grantor, whom he is legally obligated to support, except to the extent that such income is actually so applied or distributed. Where income has actually been so applied, such income is taxable to the grantor, whether or not the trust income may also be applied or distributed for purposes other than the maintenance or support of a beneficiary whom the grantor is legally obligated to support.

(b) The grantor of a trust continues to be taxable under section 167 with respect to such income as may, in the discretion of persons lacking a substantial adverse interest, be applied in discharge of his obligations other than his obligation of support or maintenance falling within section 167 (c). Thus, if the grantor creates a trust, the income of which may, in the discretion of a person lacking a substantial adverse interest, be applied in the payment of the grantor's debts, including the payment of his rent or other household expenses, such income is taxable to the grantor regardless of whether it is actually so applied.

(c) Section 167 (c) is not applicable if discretion to apply or distribute the trust income rests solely in the grantor or in the grantor in conjunction with other persons unless the grantor has such discretion as trustee.

(d) Section 167 (c) does not affect the present scope of sections 22 (k) and 171 (relating to alimony and separate maintenance payments taxable to a wife or former wife). Nor does section 167 (c) alter the provisions governing the taxability of trust income to the grantor under some other provision of law, as for example, section 22 (a). See § 29.22 (a)-21.

(e) Section 167 (c) has no application where, under the terms of the trust, income is required to be applied to the support or maintenance of a beneficiary whom the grantor is legally obligated to support.

(f) Section 167 (c) provides that in those cases where amounts applied or distributed for support or maintenance of beneficiaries whom the grantor is legally obligated to support are paid out of corpus or out of other than income for the taxable year such amounts are to be considered paid out of income to the extent of the income of the trust for such taxable year which is not paid, credited, or to be distributed under section 162 and which is not otherwise taxable to the grantor. For example, a trust indenture provides for the annual payment of income, not exceeding $7,000, to the grantor's adult son whom he is not legally obligated to support; for the payment of premiums on policies of insurance on the life of the grantor in an amount not to exceed $3,000 per annum; and for the application, in the trustee's discretion, of any part of the remaining income or of corpus for the support of the grantor's minor daughter. The entire income for the taxable year is $12,000, the trustee pays $7,000 of such income to the son and $3,000 thereof for insurance premiums, and $6,000 is applied for the support of the minor daughter. The grantor is taxable under section 167 (c) with respect to $2,000 of the sum applied to the support of the daughter, whether paid out of income or out of principal ($12,000 less $7,000 paid, credited or distributed under section 162, and less $3,000 taxable to the grantor under section 167 (a) (3)).

(g) Section 167 (c) is applicable with respect to taxable years beginning after December 31, 1942, unless a taxable year of the trust beginning in 1942 ends within a taxable year of the grantor beginning in 1943, in which case the section shall not be applicable to such taxable year of the grantor except as provided in § 29.167-3. Thus, if the returns of the trust are made on the basis of a fiscal year ending June 30, and the grantor's returns are made on the calendar year basis, section 167 (c) will be effective with respect to the trust commencing with its fiscal year beginning July 1, 1943. Since the grantor's return for the calen-

dar year 1943 includes the income of the trust's fiscal year beginning on July 1, 1942, and ending on June 30, 1943, the amendments will first be applicable with respect to the grantor to his calendar year 1944.

(h) If section 167 (c) is not invoked retroactively by the filing of consents, as provided in § 29.167-3, the grantor must include in his tax returns for taxable years beginning prior to January 1, 1943, and for a taxable year beginning in 1943 in a case described in the next preceding paragraph all the income of the trust which, in the discretion of persons lacking a substantial adverse interest, could be applied for the support or maintenance of beneficiaries whom the grantor was legally obligated to support, regardless of whether the income was so applied. The grantor, however, is not taxable on such unapplied income of the trust for those taxable years covered by any agreement entered into with the Commissioner pursuant to the provisions of I. T. 3609, Internal Revenue Bulletin 1943-10, p. 40.

[T. D. 5392, 9 F. R. 8008, as amended by T. D. 5488, 11 F. R. 68]

CROSS REFERENCE: For statement of policy regarding extent of application of this section, relating to taxability of income of certain trusts, see note to § 29.22 (a)-21.

§ 29.167-3 *Retroactive application of section 167 (c).* (a) Except for taxable years of the grantor for which allowance of credit or refund for any overpayment of tax by the grantor is barred by section 3760 of the Internal Revenue Code or a corresponding provision of prior law, relating to closing agreements, or section 3761 of the Internal Revenue Code or a corresponding provision of prior law, relating to compromises, the grantor may elect to have section 167 (c) applied retroactively upon the proper filing of consents for any taxable period of the grantor notwithstanding any other provision of the revenue laws or any rule of law, such as a prior judicial determination of the tax for the taxable period of the grantor. The election to have the section so applied is made by filing in duplicate with the Commissioner of Internal Revenue at Washington, D. C., written consents to the payment of all taxes under chapter 1 of the Internal Revenue Code or under the corresponding provisions of prior revenue laws which would have been paid for the taxable years covered by the consents if section 167 (c) had been a part of the revenue laws applicable to such taxable years.

(b) Such consents must be filed on or before whichever of the following dates is the later: (1) January 1, 1945, or (2) six months after the due date of the return of the grantor for his last taxable year to which section 167 (c) is not applicable unless the required consents are filed. Such consents must be executed by the fiduciary of the trust and all beneficiaries who would have been taxable on any income of the trust if the provisions of section 167 (c) had been a part of the revenue laws applicable to the years for which the consents are filed. If any person required to sign a consent is not in existence or is under legal disability, the consent must be signed by his legal representative. Amended returns shall accompany the consents when filed and the payment of any tax shown by such returns to be due shall be made at that time. There shall also be filed with the consents a statement by the fiduciary and each beneficiary, to the extent such parties may be entitled to refund or credit by reason of the taxability of the trust income to the grantor under the rule of *Helvering* v. *R. Douglas Stuart* (317 U. S. 154), whereby they agree not to file or prosecute any claim for refund or credit based upon such ground and a statement by the grantor agreeing to indemnify the Commissioner with respect to any such refund or credit. The Commissioner may grant a reasonable extension of time for the making of the election, if request for such extension is filed with the Commissioner prior to the date heretofore fixed for the filing of the consent or within a reasonable time thereafter, and a showing is made to his satisfaction that unusual circumstances exist, such as a case involving taxation of the grantor under the rule of *Helvering* v. *Clifford,* 309 U. S. 331, and that the granting of the extension will not jeopardize the interests of the Government.

(c) Consents filed must be applicable to all taxable years of the trust or beneficiaries corresponding to those taxable years of the grantor for which the grantor requests retroactive application of section 167 (c). Such consents must also be applicable to all other taxable years of the trust or beneficiaries for which the filing of a claim for credit or refund by the trust or beneficiaries is not barred by any provision or rule of law or

with respect to which the allowance of a credit or refund to the trust or beneficiaries without the filing of a claim is not so barred.

(d) The period of limitations on making of assessments and the beginning of distraint or a proceeding in court for collection shall with respect to any deficiency resulting from the filing of consents include one year immediately after the filing of the consents and such assessment and collection may be made notwithstanding any provision of the internal revenue laws or any rule of law (such as a prior judicial determination of the tax for the taxable period of the person signing the consent) which would otherwise prevent such assessment and collection.

(e) The period within which claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, with respect to any overpayment by the grantor resulting from the consents, shall include one year immediately after the date of the filing of the consents, and credit or refund may be allowed or made notwithstanding any provision or rule of law (other than section 134 (b) of the Revenue Act of 1943, sections 3760 and 3761 of the Internal Revenue Code or corresponding provisions of prior laws) which would otherwise prevent such credit or refund.

(f) No interest shall be allowed or paid on any overpayment or assessed on any deficiency resulting from the filing of the consents.

(g) The acceptance by the Commissioner of the filing of consents, and of any payment of tax accompanying the consents, shall not preclude the Commissioner from asserting that the grantor is taxable on income of the trust for the taxable years involved under some provision of law other than section 167 (c).

(h) Regulations 103 (26 CFR, 1938 ed., Supps., Part 19) and prior income tax regulations are amended by incorporating therein the provisions of §§ 29.167-2 and 29.167-3 to the extent necessary to accord with section 134 of the Revenue Act of 1943 as applicable to years beginning prior to January 1, 1942.

[T. D. 5392, 9 F. R. 8008]

§ 29.169-1 *Common trust fund defined.* (a) Under section 169 two conditions must be satisfied by a fund maintained by a bank (as defined in section 104) before such fund may be designated as a "common trust fund." These conditions are that such fund must be maintained by such a bank:

(1) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, whether acting alone or in conjunction with one or more co-fiduciaries, but solely in its capacity: (i) as a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (ii) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual or of an absent individual; and

(2) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System. (See 12 CFR, and 1943 Cum. Supp., 206.10 (c), 206.17 (a) to 206.17 (c).)

(b) Except as otherwise provided in this section and §§ 29.169-2 to 29.169-5, the term "participant" refers to any trust or estate, the moneys of which have been contributed to the common trust fund.

§ 29.169-2 *Income of participants in common trust fund.* (a) Each participant in a common trust fund is required to include in computing its net income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for not more than six months, computed as provided in § 29.169-3, as part of its gains and losses from sales or exchanges of capital assets held for not more than six months.

(2) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for more than six months, computed as provided in § 29.169-3, as part of its gains and losses from sales or exchanges of capital assets held for more than six months.

(3) Its proportionate share of the ordinary net income or the ordinary net

loss of the common trust fund, computed as provided in § 29.169-3.

(b) Each participant's proportionate share in the amount of interest specified in section 25 (a) received by the common trust fund shall be deemed to have been received by such participant as such interest. (For reduction of credit for such interest on account of amortizable bond premium, see § 29.125-9.) For the purposes of the Internal Revenue Code, any tax withheld at the source from income of the fund shall be deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c) The proportionate share of each participant in the gains and losses from sales or exchanges of capital assets held for not more than six months, gains and losses from sales or exchanges of capital assets held for more than six months, the ordinary net income or ordinary net loss, the partially exempt interest, and the tax withheld at the source shall be determined in accordance with the method of accounting adopted by the bank in accordance with the written plan under which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(1) The items of income and deductions are, therefore, to be allocated to the periods between valuation dates within the taxable year established by such plan in which they were realized or sustained, and the ordinary net income or ordinary net loss, gains and losses from sales or exchanges of capital assets held for not more than six months, and gains and losses from sales or exchanges of capital assets held for more than six months computed for each such period. The proportionate shares of the participants in such items are then to be determined. The provisions of this paragraph may be illustrated by the following example:

Example. The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary net income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary net income	$200	$300	$200	$400	$1,100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

The participants' shares of ordinary net income are as follows:

PARTICIPANTS' SHARES OF ORDINARY NET INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75			125
D	50				50
E		75			5
F			50	100	150
G			50	100	150
Total	200	300	200	400	1,100

The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25			75
D	50				50
E		25			25
F			50	25	75
G			50	25	75
Total	200	100	200	100	600

The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50			75
D	25				25
E		50			50
F			25	50	75
G			25	50	75
Total	100	200	100	200	600

(2) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(d) The provisions of sections **161**, **162**, **166**, and **167** are applicable in determining the extent to which each participant's proportionate share of the income of the common trust fund is taxable to the participant, or to the beneficiaries or the grantor of the participant.

§ 29.169-3 *Computation of common trust fund income.* The net income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(a) No deduction shall be allowed under section 23 (o) for charitable contributions.

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carry-over provided by section 117 (e).

(c) The ordinary net income, that is, the excess of the gross income over the deductions, or the ordinary net loss, that is, the excess of the deductions over the gross income, shall be computed after excluding gains and losses from sales or exchanges of capital assets.

§ 29.169-4 *Admission and withdrawal of participants from the common trust fund*—(a) *Gain or loss.* The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 117 (b) are unaffected by such an admission or withdrawal. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of 12 CFR 206.17 (c) (7), for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated.

(b) *Basis for gain or loss upon withdrawal.* The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the basis of the participating interest or portion thereof withdrawn (with proper adjustments as provided in section 113 (b) to the date of withdrawal) plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the money contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of 12 CFR 206.17 (c) (7). For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust to the extent that the income of the trust is taxable to the grantor pursuant to the provisions of section 166 or 167, shall be deemed to be the participant.

(c) *Additions to basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items, to the extent that they were properly allocaed to the participant for a taxable year of the common trust fund, and were not distributed to the participant prior to withdrawai:

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning

after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund for each taxable year beginning after December 31, 1937, upon sales or exchanges of capital assets held for more than 18 months (more than 6 months for taxable years beginning after December 31, 1941), and

(5) Ordinary net income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.* As prescribed in paragraph (b) of this section in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion hereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and prior to January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

§ 29.169-5 *Returns of common trust funds.* A bank maintaining a common trust fund shall make a return of income of the common trust fund, regardless of the amount of its net income. If a bank maintains more than one common trust fund, a separate return shall be made for each. The return shall be made for the taxable year of the common trust fund on the form prescribed by the Commissioner, in accordance with §§ 29.161-1 to 29.172-1 and the instructions on the form or issued therewith. The return of a common trust fund shall state specifically with respect to the fund the items of gross income and the deductions allowed under chapter 1, and shall include each participant's name and address, the ordinary net income or loss, and its proportionate share of gains and losses from sales or exchanges of capital assets. See § 29.169-2. A copy of the plan of the common trust fund must be filed with the return. If, however, a copy of such plan has once been filed with a return, it need not again be filed if the return contains a statement showing when and where it was filed. If the plan is amended in any way after such copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment was made. Each such return shall be sworn to in the same manner as the return filed by the bank under section 52.

§ 29.170-1 *Net operating loss deduction in the case of estates, trusts, and common trust funds*—(a) *Estates and trusts.* The net operating loss deduction allowed by section 23 (s), computed as provided by section 122, shall be available to estates and trusts generally, with the following exceptions and limitations:

(1) A net operating loss for a year for which a trust was exempt from tax under section 165 may not be used in the computation of the net operating loss carry-over .

(2) In computing gross income and deductions for the purposes of section 122, a trust shall exclude that portion of the income and deductions attributable to the grantor under section 166 and § 29.166-1 (c).

(3) An estate or trust shall not, for the purposes of section 122, avail itself of the deductions allowed by section 162.

(b) *Common trust funds.* The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction a participant in a common trust fund shall take into account its pro rata share of the income and losses of the common trust fund as prescribed by § 29.189-1 in the case of partners.

§ 29.171-1 *Income of trust in case of divorce, etc.*—(a) *In general.* (1) Section 171 (a) provides rules in certain cases for taxability of income of trusts as between spouses who are divorced or legally separated under a court order or decree. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligation such payments are made. For convenience, the beneficiary spouse will hereafter in this section and in § 29.171-2 be referred to as the "wife"

and the obligor spouse from whom she is divorced or legally separated as the "husband." (See section 3797 (a) (17).) Thus, under section 171 (a) income of a trust:

(i) Which is paid, credited or to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 171, would be includible in the gross income of her husband.

shall be includible in her gross income and shall not be includible in his gross income.

(2) Section 171 (a) does not apply in any case to which section 22 (k) applies. Although section 171 (a) and section 22 (k) seemingly cover some of the same situations there are important differences between them. Thus, section 171 (a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 22 (k) applies only if the creation of the trust or payments by a previously created trust are in discharge of a legal obligation imposed upon or assumed by the husband (or made specific) under the court decree or an instrument incident to the divorce or legal separation. On the other hand, section 22 (k) requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while section 171 (a) requires amounts paid, credited or to be distributed to her to be included only to the extent such amounts are out of income of the trust for its taxable year (determined as provided in section 162).

(3) Section 171 (a) is designed to produce uniformity as between cases described in section 171 (a) and cases not described in section 171 (a), where, in the former cases, without section 171 (a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his former wife, and where, in the latter cases, the income of a so-called alimony trust is taxable to the former wife because of the termination of the husband's obligation. Furthermore, section 171 (a) taxes trust income to the wife in all cases where under prior law the husband would be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the income or trust corpus. Section 171 (a) applies whether or not the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 171 (a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example (1). Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income therefrom to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and none is ordered by the court; the court, however, has jurisdiction under the law of the State to order at any time prior to an absolute divorce that provision be made by H for W's support. Under the provisions of section 171 (a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part thereof is includible in H's income or deductible by him.

Example (2). H transfer property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, such $100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children.* Section 171 (a) does not require the inclusion in the wife's income of trust income which the terms of the decree or trust instrument fix in terms of an amount of money or a portion of such income as a sum which is payable for the support of minor children of the husband. The statute prescribes the treatment in cases where under the terms of the decree or trust instrument a specific amount of trust income is to be paid but a lesser amount becomes payable. In such cases, to the extent of the sum which would be payable for such support out of the originally specified amount of trust income, such trust income is considered payable for support of such minor children. This rule is similar to that provided in the case of periodic payments under section 22 (k). See § 29.22 (k)-1 (d).

§ 29.171-2 *Application of trust rules to alimony payments.* (a) For the purpose of the application of sections 162, 163, and 164, the wife described in section 171 or section 22 (k) who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations.

(b) A periodic payment includible in the wife's gross income under section 22 (k) attributable to property in trust shall be included in full in her gross income in her taxable year in which any part is required to be included under sections 162 and 164. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1942, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1943. Although the periodic payment is received by the wife in 1943, since under sections 162 and 164 the $4,000 income distributable on December 31, 1942, is to be included in the wife's income for 1942, the $1,000 payment out of corpus is to be included in her income for 1942.

§ 29.172-1 *Amortization of emergency facility of estate or trust.* In the case of an emergency facility, as defined in section 124 (e), acquired or completed by an estate or trust after December 31, 1939, such estate or trust is entitled to take amortization deductions with respect thereto in the same manner and to the same extent as in the case of an individual. See section 23 (t) and section 124 and the regulations thereunder. The principles governing the apportionment of depreciation in the case of property held in trust are applicable with respect to the amortization of an emergency facility of an estate or trust. See § 29.23 (l)-1.

PARTNERSHIPS

§ 29.181-1 *Partnerships.* Partnerships as such are not subject to the income tax imposed by chapter 1, but are required to make returns of income. (See sections 187 and 188.) For definition of what the term "partnership" includes, see section 3797 (a) (2).

§ 29.182-1 *Distributive share of partners.* (a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

(1) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.

(2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.

(3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(b) If separate returns are made by the husband and wife domiciled in a community property State, and the husband only is a member of a partnership, the part of his distributive share of gains and losses of the partnership from sales or exchanges of capital assets or the part of his distributive share of ordinary net income or ordinary net loss, which is, or is derived from, community property should be reported by the husband and by the wife in equal proportions. In the case of a partnership closely related to other trades or businesses, see section 45.

§ 29.183-1 *Computation of partnership income.* The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that:

(a) The partnership is required to segregate its gains and losses from sales or exchanges of capital assets. A partnership is not allowed the benefit of section 117 (e).

(b) The partnership is further required, after excluding all items described in paragraph (a) of this section, to compute (1) an ordinary net income which consists of the excess of gross income over the deductions, or (2) an ordinary net loss which consists of the excess of the deductions over the gross income. In the computation of its ordinary net income or ordinary net loss, the partnership is denied the so-called charitable

contribution deduction allowed by section 23 (o), but each partner is considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of a character which would be allowed to the partnership as a deduction if section 183 (c) had not been enacted. Payments made to a partner for services rendered and for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partnership profits.

§ 29.184-1 *Credits allowed partners.* The credits against net income provided in section 25 are not applicable to partnerships as such. An individual partner, however, is entitled for the purpose of the normal tax to a credit against his net income, in addition to the credits allowed to him under section 25, of his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership. There shall be included in the return of the partnership a statement of the amounts of such interest and the proportionate share thereof of each partner. (For reduction of credit for such interest on account of amortizable bond premium, see § 29.125-9.)

§ 29.185-1 *Earned income credit of partners.* (a) For the purpose of computing the earned income credit for a taxable year beginning before January 1, 1944, against net income, a member of a partnership is entitled to treat a proper part of his distributive share of the partnership net income as earned income. Such part cannot exceed a reasonable allowance as compensation for personal services actually rendered by the partner in connection with the partnership business. In the case of a partnership which is engaged in a trade or business in which capital is a material income-producing factor and in the trade or business of which the partner renders personal services which are material to the earning of the partnership income, the earned income of the partner from the partnership is a reasonable allowance as compensation for the personal services actually rendered by him, but not in excess of 20 percent of his share of the net profits of the partnership (computed without deduction for so-called salaries to members). In such a case, if reasonable compensation is less than 20 percent of the partner's share of the net profits, the earned income is the full amount of the reasonable compensation, but, if reasonable compensation is more than 20 percent of the partner's share of the net profits, then the earned income is 20 percent of the partner's share of such profits.

(b) There must be included in the return of the partnership a statement showing the names of the members and the amount (determined in accordance with paragraph (a) of this section) of each partner's distributive share of the partnership net income which consists of earned income.

Example. A partnership composed of A, B, and C is engaged in the retail men's clothing business. Each partner is entitled to one-third of the net profits, after deduction of so-called salaries to members. A devotes most of his time to the business and is paid a salary of $10,000. B devotes half of his time to the business and is paid a salary of $5,000. C devotes none of his time to the business and receives no salary. The net profits of the partnership for the taxable year, computed without deduction for so-called salaries to members, are $24,000. The earned income of the partners from the partnership is as follows: Although A received a salary of $10,-000 and B a salary of $5,000, since the partnership is engaged in a business in which capital is a material income-producing factor, the earned income of each from the partnership is limited to 20 percent of his share of the net profits. A's share of the net profits is $13,000 ($10,000 (salary)+$3,000 (⅓ of net profits after deduction of $15,000 for salaries)). Twenty percent of $13,000 is $2,600, to which amount A's earned income from the partnership is limited. Since B's share of the net profits is $8,000 ($5,000+$3,000), 20 percent thereof, or $1,600, is B's earned income from the partnership. C has no earned income from the partnership, since he renders no personal services in connection with the partnership business.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5373, 9 F. R. 5502]

§ 29.187-1 *Partnership returns.* Every partnership shall make a return of income, regardless of the amount of its net income (see section 3797 (a) (2), defining the term "partnership"). The return shall be on Form 1065; shall state specifically the information required to be stated by the return form; shall be filled in according to the instructions contained thereon, or issued with respect thereto; and shall be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership,

that is, for its annual accounting period (fiscal year or calendar year, as the case may be), irrespective of the taxable years of the partners. (See sections 182 and 183.) If the partnership makes any change in its accounting period, it shall make its return in accordance with the provisions of section 47, except that the return shall not be placed on an annual basis under section 47 (c).

§ 29.189-1 *Net operating loss deduction in the case of partners.* The benefit of the deduction for net operating losses provided by section 23 (s) shall not be allowed to a partnership. In computing his own net operating loss or his own net income (where required to be computed in accordance with the exceptions and limitations provided in section 122 (d) (1) to (4), inclusive) for any taxable year for the purposes of the computations required by section 122, however, each partner shall take into account the income and losses of the partnership in accordance with sections 182 to 188, inclusive, with the following exceptions and limitations:

(a) *Exceptions and limitations applicable in computation of partner's net operating loss*—(1) *Long-term capital gains and losses.* The partnership's gains and losses from sales or exchanges of capital assets held for more than six months shall be taken into account without regard to the percentage provisions of section 117 (b). The business gains and losses from sales or exchanges of capital assets held for more than six months and the nonbusiness gains and losses from such sales or exchanges shall be segregated and his distributive share of the partnership's business gains or losses from such sales or exchanges and the partnership's nonbusiness gains and losses from such sales or exchanges shall be included by each partner as business and nonbusiness gains or losses from the sales or exchanges of capital assets held for more than six months, respectively.

(2) *Short-term capital gains and losses.* The partnership's business gains and losses from sales or exchanges of capital assets held for not more than six months and the partnership's nonbusiness gains and losses from such sales or exchanges shall be segregated, and his distributive share of such business gains or losses and such nonbusiness gains or losses shall be included by each partner as business and nonbusiness gains or losses from sales or exchanges of capital assets held for not more than six months, respectively.

(3) *Ordinary net income or loss.* (i) After excluding all items required to be segregated by subparagraphs (1) and (2) of this paragraph, there shall be computed:

(*a*) A business ordinary net income of the partnership, which shall consist of the excess of the business gross income over the business deductions; or

(*b*) A business ordinary net loss of the partnership, which shall consist of the excess of the business deductions over the business gross income; and

(*c*) A nonbusiness ordinary net income of the partnership, which shall consist of the excess of the nonbusiness gross income over the nonbusiness deductions; or

(d) A nonbusiness ordinary net loss of the partnership, which shall consist of the excess of the nonbusiness deductions over the nonbusiness gross income.

(ii) In making the computations shown in subdivisions (i) (*a*) to (*d*) of this subparagraph the limitations and exceptions provided by section 122 (d) (1) and (2) shall be applied.

(iii) His distributive share of a business ordinary net income of the partnership shall be included by each partner as ordinary business gross income, and of a business ordinary net loss of the partnership as an ordinary business deduction. His distributive share of a nonbusiness ordinary net income of the partnership shall be included by each partner as ordinary nonbusiness gross income, and of a nonbusiness ordinary net loss of the partnership as an ordinary nonbusiness deduction.

(b) *Exceptions and limitations applicable in computation of partner's net income.* (1) The ordinary net income or ordinary net loss of the partnership shall be computed with the exceptions and limitations provided in section 122 (d) (1) and (2).

(2) The gains and losses from sales or exchanges of capital assets of the partnership shall be taken into account without regard to the percentage provisions of section 117 (b).

§ 29.190-1 *Amortization of emergency facility of partnership.* In the case of an emergency facility, as defined in section 124 (e), acquired or completed

by a partnership after December 31, 1939, the partnership is entitled to take amortization deductions with respect thereto in the same manner and to the same extent as in the case of an individual. See section 23 (t) and section 124 and the regulations thereunder. Amortization deductions with respect to an emergency facility of a partnership are not allowed to the members of the partnership.

INSURANCE COMPANIES

§ 29.201-1 *Tax on life insurance companies.* (a) All life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 201 (b) are subject to both normal tax and surtax. The normal tax is imposed on the adjusted normal-tax net income (as defined in section 202) and the surtax is imposed on the adjusted corporation surtax net income (as defined in section 203) at the rates provided in section 13 or section 14 (b) and in section 15 (b).

(b) The net income of life insurance companies differs from the net income of other corporations. See section 201 (c). Life insurance companies are entitled, in computing normal-tax net income and corporation turtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a), respectively. The gross income, the deduction under section 201 (c) (7) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 201 (e) and § 29.201-9. Such companies are not subject to the provisions of section 117 (capital gains and losses) nor to the provisions of section 125 (amortizable bond premiums). For computation of the adjusted normal-tax net income from normal-tax net income and the adjusted corporation surtax net income from corporation surtax net income, see §§ 29.202-1, 29.202-2 and 29.203-1.

(c) All provisions of the Internal Revenue Code and of this part not inconsistent with the specific provisions of sections 201 to 203, inclusive, are applicable to the assessment and collection of the tax imposed by section 201 (a), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 201 (a), but are taxable as other foreign corporations. See section 231.

§ 29.201-2 *Foreign life insurance companies.* A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 201 (b), is taxable on its income received during the taxable year from interest dividends, and rents, from sources within and without the United States, pertaining to its United States business. Such a company is taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of chapter 1, such as gross income, the adjustment for certain reserves, deductions and limitations on deductions, amortization of premiums and accrual of discount and the credits provided in section 26, shall be made on the basis of the income disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Life Insurance Commissioners. This statement is presumed clearly to reflect the income disbursements, assets, and liabilities of the United States business of the company and in so far as it is not inconsistent with the provisions of the Internal Revenue Code will be recognized and used as a basis for that purpose.

§ 29.201-3 *Life insurance companies; definition.* The term "life insurance company" as used in chapter 1 is defined in section 201 (b). In determining whether an insurance company is a life insurance company the life insurance reserves (as defined in section 201 (c) (2)) plus any unearned premiums and unpaid losses on noncancelable life, health, or accident policies, not included in "life insurance reserves" must comprise more than 50 percent of its total reserves (as

defined in section 201 (b)). An insurance company writing only noncancelable life, health, or accident policies and having no "life insurance reserves" may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancelable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. A burial or funeral benefit insurance company qualifying as a life insurance company shall continue to be taxed under section 201 for taxable years beginning prior to January 1, 1944. For taxable years beginning after December 31, 1943, any such company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 204 or section 207 as an insurance company other than life. For the definition of an insurance company see § *29.3797-7*.

§ 29.201-4 *Life insurance reserves.* (a) The term "life insurance reserves" is defined in section 201 (c) (2). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancelable health and accident policies and similar cancelable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancelable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or by-laws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 201 (c) (2), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 201 (c) (2), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by

this particular class of companies but they need not be required by law.

§ 29.201-5 *Interest paid.* Interest paid is one of the elements to be used, together with adjusted reserves, reserve earnings rate, and reserve for deferred dividends, in arriving at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b) (see § 29.202-1). Interest paid consists of (1) interest paid on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 201 (c) (6) (A)) and (2) amounts in the nature of interest paid on certain contracts, as provided in section 201 (c) (6) (B). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid on deferred dividends the reserve for which is used in determining the policy and other liability credit provided in section 202 (b). Life insurance reserves as defined in § 29.201-4 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment, life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment and the full amount of the interest paid and not merely the guaranteed interest is considered as interest paid.

§ 29.201-6 *Adjusted reserves.* For the purpose of determining the figure to be proclaimed by the Secretary under the formula set forth in section 202 (b), certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent (see § 29.202-1). The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves as thus adjusted, and the rate of interest on which they are computed should be reported in Schedule A, Form 1120L.

§ 29.201-7 *Net income and deductions*—(a) *In general.* The net income of a life insurance company is its gross amount of income received during the taxable year from interest, dividends, and rents, less the deductions provided in section 201 (c) (7) for wholly tax-exempt interest, investment expenses, real estate expenses, and depreciation. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 201 (d), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 201 (e), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 201 (c) (7) (B), life insurance companies are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 24 (a) (5). Life insurance companies are not entitled to the net operating loss deduction provided in section 23 (s).

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 22 (b) (4) but included in the gross income of a life insurance company by section 201 (c) (1) is allowed as a deduction from gross income by section 201 (c) (7) (A).

(c) *Investment expenses.* (1) The term "general expenses" as used in the Internal Revenue Code means any expense incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 201 (c) (7) (B) subjects the entire deduction for investment expenses to the limitation provided in that section. The account-

ing procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses actually paid during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 201 (c) (7) (B) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 201 (c) (1). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses the maximum allowance will not be granted unless it is shown to the satisfaction of the Commissioner that such allowance is justified by a reasonable assignment of actual expenses.

(4) Wages or salaries included in investment expenses shall be disallowed as a deduction if determined by the National War Labor Board, the Secretary of Agriculture, or the Commissioner to have been made in contravention of the Act of October 2, 1942 (56 Stat. 765, 5 U. S. C., Sup. 961), entitled "An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes," or of the regulations, orders, or rulings promulgated thereunder.

(d) *Taxes and expenses with respect to real estate.* The deduction for taxes and expenses under section 201 (c) (7) (C) includes taxes and expenses paid during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid by the company without reimbursement from the shareholder. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. (See paragraph (c) of this section.) As to real estate owned and occupied by the company see § 29.201-8.

(e) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 201 (d), identical with that allowed other corporations by section 23 (l). The amount allowed by section 23 (l) in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 201 (c) (1).

§ 29.201-8 *Real estate owned and occupied.* The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

§ 29.201-9 *Amortization of premium and accrual of discount.* (a) Section 201 (e) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the credit for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value

over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined:

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the company (including a company which followed a different method in taxable years beginning prior to January 1, 1942) initiates on or before March 15, 1943, or in the first taxable year for which the adjustments are made, a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter, Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

§ 29.202-1 *Reserve and other policy liability credit for adjusted normal-tax net income.* (a) Life insurance companies in computing adjusted normal-tax net income are allowed a "reserve and other policy liability credit" in lieu of a deduction for the interest allowed on their reserves, for interest paid and for deferred dividends. This credit is a flat percentage of normal-tax net income The figure is the same for all companies and is determined on the basis of the aggregate of the interest allowed on reserves, interest paid, and 2 percent of the reserves held for deferred dividends, as provided in section 202 (b), for all companies. The figure for each taxable year is to be determined and proclaimed by the Secretary, based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative for such year.

(b) The application of the reserve and other policy liability credit for the purpose of this section and section 203 may be illustrated by the following examples:

Example (1). The X Life Insurance Company for the calendar year 1942 has gross income, consisting of interest and rents, of $4,000,000, of which $700,000 consists of wholly tax-exempt interest. It has investment expenses of $100,000, real estate expenses of $80,000, and depreciation of $20,000. Its net income and its normal-tax net income is accordingly $3,100,000 ($4,000,000 less investment expenses, real estate expenses, and depreciation amounting to $200,000 and

wholly tax-exempt interest of $700,000). Since the Secretary has determined and proclaimed that for the taxable year 1942 the figure based on data for the taxable year 1941 is 0.93, the X Life Insurance Company is entitled to a credit of $2,883,000 ($3,100,000×0.93) and its adjusted normal-tax net income as well as its adjusted corporation surtax net income is $217,000 ($3,100,000−$2,883,000).

Example (2). If in example (1) $100,000 of the $4,000,000 gross income of the X Life Insurance Company for the calendar year 1942 consisted of partially tax-exempt interest, in addition to the $700,000 of wholly tax-exempt interest, its corporation surtax net income and adjusted corporation surtax net income would be the same as in the above example. Its normal-tax net income, however, would be $3,000,000 ($4,000,000 less $200,000 less $700,000 less $100,000), its credit would be $2,790,000 ($3,000,000×0.93) and its adjusted normal-tax net income would be $210,000 ($3,000,0000–$2,790,000).

§ 29.202-2 *Adjustment for certain reserves.* A life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its normal-tax net income and to its corporation surtax net income, as an offset to its reserve and other policy liability credit, an amount equal to 3¼ percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the amount to be added to normal-tax net income and to corporation surtax net income is 3¼ percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3¼ percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. The term "unearned premiums" when used in this section has the same meaning as in section 204 (b) (5) and the regulations thereunder.

§ 29.203-1 *Reserve and other policy liability credit for adjusted corporation surtax net income.* Life insurance companies in computing adjusted corporation surtax net income are allowed a reserve and other policy liability credit. This credit is similar to that provided in section 202 except that it is based on corporation surtax net income, which includes partially tax-exempt interest. See § 20.202-1 for the application and effect of this provision.

§ 29.204-1 *Tax on insurance companies other than life or mutual and mutual marine insurance companies and mutual fire insurance companies issuing perpetual policies.* (a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 204. The term "insurance companies" as used in this section and §§ 29.204-2 and 29.204-3 means only those companies subject to the tax imposed by section 204. For what constitutes an insurance company, see § 29.3797-7. The net income of insurance companies is defined in section 204 and differs from the net income of other corporations. All provisions of the Internal Revenue Code and of this part not inconsistent with the specific provisions of section 204 are applicable to the assessment and collection of the tax imposed by section 204 (a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. Since section 204 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 204 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a).

(b) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 204 but are taxable as other foreign corporations. See section 231.

(c) Insurance companies are subject to both normal tax and surtax. The normal tax shall be at the rate specified in

section 13 (b) if the company has a normal-tax net income of more than $25,000, or at the rate specified in section 14 (b) if it has a normal-tax net income of not more than $25,000. For what constitutes normal-tax net income, see § 29.13–1. The surtax shall be at the rate specified in section 15 (b) (1) if the company has a corporation surtax net income of not more than $25,000, at the rate specified in section 15 (b) (2), if it has a corporation surtax net income of more than $25,000 and not more than $50,000, or at the rate specified in section 15 (b) (3) if it has a corporation surtax net income of more than $50,000. For what constitutes corporation surtax net income, see § 29.15–1. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) and the regulations thereunder.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5109]

§ 29.204–2 *Gross income.* (a) Gross income as defined in section 204 (b) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 22, except that in the case of a mutual fire insurance company described in § 29.204–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. See section 22 (a), (b), and (c) and sections 28 and 334. It does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company, and in so far as it is not inconsistent with the provisions of the Internal Revenue Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 201 (c) (2) and § 29.201–4 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 204 and not qualifying as a life insurance company under section 201 (b), and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums. In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) For taxable years beginning after December 31, 1943 every insurance company to which this section applies must be prepared to establish to the satisfaction of the Commissioner of Internal Revenue that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the Commissioner, are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. For taxable years beginning after December 31, 1943, the Commissioner may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) For taxable years beginning after December 31, 1946, that part of the deduction for "losses incurred" which represents an adjustment to "losses paid" for "salvage and reinsurance recoverable" shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of "losses paid", outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year. To the extent attributable to losses paid prior to January 1, 1947, salvage and reinsurance shall be accounted for in accordance with the practice of the company as reflected in its income tax return for the year 1946.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5109, T. D. 5387, 9 F. R. 7371, T. D. 5593, 12 F. R. 8229]

§ 29.204-3 *Deductions.* (a) The deductions allowable are specified in section 204 (c) and by reason of the provisions of section 204 (c) (10) include deductions (other than those specified in section 204 (c)) as provided in section 23. The deductions, however, are subject to the limitation provided in section 24 (a) (5). The net operating loss deduction allowed by section 23 (s) is computed under section 122 and the regulations thereunder. In computing net operating loss or net income of insurance companies for the purposes of section 122 "gross income" shall mean gross income as defined in section 204 (b) (1) and the allowable deductions shall be those allowed by section 204 (c) with the exceptions and limitations set forth in section 122 (d). In addition to the deduction for capital losses provided in section 117, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the 5-year capital loss carry-over provisions of section 117 (e). The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 207, see section 207 (b) (4) (F) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 29.204-1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 207, see section 207 (b) (3) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing net income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 117 (d) (1). The graduated percentage reduction of gains and losses contained in section 117 (b) does not apply in the case of insurance companies but they are entitled to the alternative taxes provided in section 117 (c).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5110]

§ 29.207-1 *Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 204*—(a) *General.* (1) All mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under sections 201 or 204 and not specifically

exempt under the provisions of section 101 (11), are subject to the tax imposed by section 207 (a) on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternate tax, in lieu of the tax imposed by section 207 (a) (1) or (3), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) (1) and the regulations thereunder.

(2) The taxable income of mutual insurance companies other than life or marine differs from the taxable income of other corporations. See section 207 (a) (2) and section 207 (b). Such companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a). The gross amount of income during the taxable year from interest, the deductions under section 207 (b) (4) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premiums and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 207. See section 207 (d) and § 29.207-6.

(3) All provisions of the Internal Revenue Code and of this part not inconsistent with the specific provisions of section 207 are applicable to the assessment and collection of the tax imposed by section 207 (a) and mutual insurance companies subject to the tax imposed by section 207 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 207 (a), but are taxable as other foreign corporations. See section 231.

(5) Mutual insurance companies subject to the tax imposed by section 207, except interinsurers or reciprocal underwriters, with corporation surtax net incomes of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest of over $75,000, are subject to a tax computed under section 207 (a) (1) or section 207 (a) (2) whichever is the greater. Interinsurers and reciprocal underwriters with corporation surtax net incomes of over $50,000 are subject to a tax computed under section 207 (a) (3).

(b) *Taxable years beginning prior to January 1, 1946.* (1) For any taxable year beginning prior to January 1, 1946, the tax under section 207 (a) (1) and 207 (a) (3), except as hereinafter indicated, is computed upon normal-tax net income and corporation surtax net income at the rates provided in section 13 or section 14 (b) and in section 15 (b) applicable to such year. The tax under section 207 (a) (2), except as hereinafter indicated, is a tax equal to the excess of 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, over the amount of the tax imposed under subchapter E of chapter 2.

(2) Under section 207 (a) (1), companies with normal-tax net incomes of between $3,000 and $6,153.86, and with corporation surtax net incomes of between $3,000 and $6,000, pay a normal tax, at the rate of 30 percent, and a surtax, at the rate of 20 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $3,000. Under section 207 (a) (2), companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, of between $75,000 and $150,000, pay a tax equal to the excess of 2 percent of that portion in excess of $75,000, over the amount of the tax imposed under subchapter E of chapter 2. Under section 207 (a) (3) interinsurers and reciprocal underwriters with normal-tax net incomes and corporation surtax net incomes of between $50,000 and $100,000 pay a normal tax, at the rate of 48 percent, and a surtax, at the rate of 32 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $50,000.

(3) Section 207 (a) (4) provides for an adjustment of the amount computed under section 207 (a) (1), section 207

(a) (2) (A), and section 207 (a) (3) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(4) The application of section 207 (a) (1), (2), (3), and (4) may be illustrated by the following examples:

Example (1). The X Company, a mutual casualty insurance company, for the taxable year 1942 has a corporation surtax net income of $3,500 and due to partially tax-exempt interest of $600, a normal-tax net income of $2,900. The gross amount of income of the X Company from interest, dividends, rents, net premiums, minus dividends to policyholders, minus wholly tax-exempt interest is $150,000. Its excess profits net income is $2,900. It is not subject to normal tax under section 207 (a) (1) for the taxable year 1942 as its normal-tax net income does not exceed $3,000. Its surtax is 20 percent of $500 ($3,500–$3,000) or $100, since that amount is less than $350, the surtax computed at the rate provided in section 15 (b). It has no normal tax and, therefore, its total tax under section 207 (a) (1) is the surtax of $100. Its excess profits net income is less than $5,000 and, therefore, there is no excess profits tax and the tax under section 207 (a) (2) is 1 percent of $150,000, or $1,500. Since the tax under section 207 (a) (2) exceeds the tax under section 207 (a) (1), the tax under section 207 (a) is $1,500, namely, that imposed by section 207 (a) (2).

Example (2). If in the above example the normal-tax net income, corporation surtax net income, and excess profits net income were each less than $2,900, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) was $90,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest was $70,000, the X Company would be required to file an income tax return but due to section 207 (a) no income tax would be imposed.

Example (3). The Y Company, a mutual fire insurance company, subject to the tax imposed by section 207 for the taxable year 1942 has a normal-tax net income of $6,000, a corporation surtax net income of $7,000, and an adjusted excess profits net income of $1,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $120,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest is $100,000. Under section 207 (a) (1), without application of section 207 (a) (4), the normal tax would be 30 percent of $3,000, or $900 (since this is less than $920, the tax computed at the rates provided in section 14 (b); and the surtax would be 10 percent of $7,000, or $700 (since this is less than $800, the tax computed at 20 percent of the excess of the surtax net income over $3,000). The combined tax of $1,600 would then be reduced by applying section 207 (a) (4), since the gross receipts are between $75,000 and $125,000. The final tax under section 207 (a) (1) would be 90 percent of $1,600, or $1,440, since the $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000. The excess profits tax on the adjusted excess profits net income of $1,000 at the rate of 90 percent is $900 (this being less than the 80 percent limitation under section 710 (a) (1) (B). Under the provisions of section 710 (a), after applying section 710 (a) (4), the excess profits tax is $810 (90 percent of $900) since $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 207 (a) (2) (A), without reference to section 207 (a) (4), the tax is 2 percent of $25,000 (the excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 207 (a) (4) reduces this to $450, or 90 percent of $500. Since $450 is less than the amount of the excess profits tax of $810 there is no tax under section 207 (a) (2) and the tax under section 207 (a) (1) is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $1,440 and an excess profits tax of $810 or a total of $2,250.

Example (4). The Z Exchange, an inter-insurer, for the taxable year 1942 has a corporation surtax net income of $60,000 and, due to partially tax-exempt interest of $12,000, a normal-tax net income of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not subject to normal tax under section 207 (a) (3) for the taxable year 1942 as its normal-tax net income is less than $50,000. Its surtax is 32 percent of $10,000 ($60,000–$50,000) or $3,200, since that amount is less than $9,600, the surtax computed at the rate provided in section 15 (b). Since it has no normal tax and is not subject to the tax imposed by section 207 (a) (2) nor entitled to the adjustment provided in section 207 (a) (4), its total tax under section 207 (a) is $3,200.

(c) *Taxable years beginning after December 31, 1945.* (1) For any taxable year beginning after December 31, 1945, the tax under section 207 (a) (1) and 207 (a) (3), except as hereinafter indicated, is computed upon normal-tax net income and corporation surtax net income at the rates provided in section 13 or section 14 (b) and in section 15 (b) applicable

to such year. The tax under section 207 (a) (2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest.

(2) Under section 207 (a) (1) companies with normal-tax net incomes of between $3,000 and $6,153.86 and with corporation surtax net incomes of between $3,000 and $6,000, pay a normal tax, at the rate of 30 percent, and a surtax, at the rate of 12 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $3,000. Under section 207 (a) (2), companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, of between $75,000 and $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000. Under section 207 (a) (3) interinsurers and reciprocal underwriters with normal-tax net incomes and corporation surtax net incomes of between $50,000 and $100,000 pay a normal tax, at the rate of 48 percent, and a surtax, at the rate of 28 percent, on that portion of the normal-tax net income and the corporation surtax net income, respectively, in excess of $50,000.

(3) Section 207 (a) (4) provides for an adjustment of the amount computed under section 207 (a) (1), section 207 (a) (2) (A), and section 207 (a) (3) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(4) The application of section 207 (a) (1), (2), (3), and (4) may be illustrated by the following examples:

Example (1). The X Company, a mutual casualty insurance company, for the taxable year 1946 has a corporation surtax net income of $3,500 and due to partially tax-exempt interest of $600, a normal-tax net income of $2,900. The gross amount of income of the X Company from interest, dividends, rents, net premiums, minus dividends to policyholders, minus wholly tax-exempt interest is $150,000. It is not subject to normal tax under section 207 (a) (1) for the taxable year 1946 as its normal-tax net income does not exceed $3,000. Its surtax is 12 percent of $500 ($3,500–$3,000) or $60, since its surtax net income is not more than $6,000. It has no normal tax and, therefore, its total tax under section 207 (a) (1) is the surtax of $60. The tax under section 207 (a) (2) is 1 percent of $150,000, or $1,500. Since the tax under section 207 (a) (2) exceeds the tax under section 207 (a) (1), the tax under section 207 (a) is $1,500, namely, that imposed by section 207 (a) (2).

Example (2). If in the above example the normal-tax net income and the corporation surtax net income were each less than $2,900, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) was $90,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest was $70,000, the X Company would be required to file an income tax return but due to section 207 (a) no income tax would be imposed.

Example (3). The Y Company, a mutual fire insurance company subject to the tax imposed by section 207, for the taxable year 1946 has a normal-tax net income of $6,000 and a corporation surtax net income of $7,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $120,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest is $100,000. Under section 207 (a) (1), without application of section 207 (a) (4), the normal tax would be 30 percent of $3,000, or $900, since this is less than $920, the tax computed at the rates provided in section 14 (b); and the surtax would be 6 percent of $7,000, or $420, the rate provided in section 15 (b) (1), since its surtax net income exceeds $6,000 but does not exceed $25,000. The combined tax of $1,320 would then be reduced by applying section 207 (a) (4), since the gross receipts are between $75,000 and $125,000. The tax under section 207 (a) (1), as thus adjusted, would be 90 percent of $1,320, or $1,188, since $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000.

Under section 207 (a) (2) (A), without reference to section 207 (a) (4), the tax is 2 percent of $25,000 (the excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 207 (a) (4) reduces this to $450, or 90 percent of $500. Since $1,188, the tax under section 207 (a) (1), as adjusted, exceeds $450, the tax under section 207 (a) (2), as adjusted, the tax under section 207 (a) (1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $1,188.

Example (4). The Z Exchange, an interinsurer, for the taxable year 1946 has a corporation surtax net income of $60,000 and, due to partially tax-exempt interest of $12,000, a normal-tax net income of $48,000.

The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not subject to normal tax under section 207 (a) (3) for the taxable year 1946 as its normal-tax net income is less than $50,000. Its surtax is 28 percent of $10,000 ($60,000—$50,000) or $2,800, since that amount is less than $8,400, the surtax computed at the rate provided in section 15 (b). Since it has no normal tax and is not subject to the tax imposed by section 207 (a) (2) nor entitled to the adjustment provided in section 207 (a) (4), its total tax under section 207 (a) is $2,800.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 8 F. R. 5110, T. D. 5497, 11 F. R. 2160, T. D. 5600, 13 F. R. 577]

§ 29.207-2 *Net premiums.* Net premiums are one of the items used together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 207 (a) (2). They are also used in section 207 (b) (4) (F) in determining the limitation on certain capital losses and in the application of section 117 (e). The term "net premiums" is defined in section 207 (b) (2) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 207 (b) (3).

§ 29.207-3 *Dividends to policyholders.* (a) "Dividends to policyholders" is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 207 (a) (2). They are also used in section 207 (b) (4) (F) in determining the limitation on certain capital losses and in the application of section 117 (e). The term "dividends to policyholders" is defined in section 207 (b) (3) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 207 (b) (2). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company on the accrual basis does not use the above method in determining the deduction for dividends and similar distributions declared to policyholders, it must submit with its return a full and complete explanation of the method actually used. For the rule as to when dividends are considered paid, see § 29.27 (b)-2 (a).

§ 29.207-4 *Net income and deductions*—(a) *In general.* The net income of a mutual insurance company other than life or marine in its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in section 117, less the deductions provided in section 207 (b) (4) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, and capital losses. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 207, provided in section 207 (c), the adjustment for amortization of premium and acrual of discount provided in section 207 (d), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 207 (b) (4) (B), mutual insurance companies subject to

the tax imposed by section 207 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 24 (a) (5). Such companies are not entitled to the net operating loss deduction provided in section 23 (s).

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 22 (b) (4) but included in the gross investment income by section 207 (b) (1) is allowed as a deduction from gross investment income by section 207 (b) (4) (A).

(c) *Investment expenses.* The deduction allowed by section 207 (b) (4) (B) for investment expenses is the same as that allowed life insurance companies by section 201 (c) (7) (B) except that provision is made for both the cash and accrual method of accounting. (See § 29.201-7 (c).)

(d) *Taxes and expenses with respect to real estate.* The deduction allowed by section 207 (b) (4) (C) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 201 (c) (7) (C) except that provision is made for both the cash and accrual method of accounting. (See § 29.201-7 (d).)

(e) *Depreciation.* The deduction allowed by section 207 (b) (4) (D) for depreciation is the same as that allowed life insurance companies by section 201 (c) (7) (D). (See § 29.201-7 (e).)

(f) *Interest paid or accrued.* The deduction allowed by section 207 (b) (4) (E) for interest on indebtedness is the same as that allowed other corporations by section 23 (b). (See § 29.23 (b)-1.)

(g) *Capital losses.* (1) The deduction for capital losses under section 207 (b) (4) (F) includes not only capital losses to the extent provided in section 117 but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under section 117 is limited to the gains. (See section 117 (d) (1).)

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 207 (b) (4) (F), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provision of section 117. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 117 (e).

(3) The application of section 207 (b) (4) (F) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 207, in the taxable year 1942 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000, losses of $25,000, and expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in the above example the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under section 117.

Example (3). If in example (1) the X Company had a corporation surtax net income of $9,750 and, under the provisions of section 117, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1942 in applying section 117 (e) for the purposes of section 207 (b) (4) (F), would be $8,000. This is determined by subtracting from total losses of $33,000 ($18,000 capital losses under section 117 plus $20,000 other capital losses under section 207 (b) (4) (F)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than corporation surtax net income, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 corporation surtax net income plus $20,000 other capital losses under section 207 (b) (4) (F) plus the portion of capital losses allowable under section 117 of $10,000 minus capital gains under section 117 of $10,000).

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5110, T. D. 5458, 10 F. R. 7335]

§ 29.207-5 *Real estate owned and occupied.* The limitation in section 207 (c) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 207 is the same as that provided in the case of life insurance companies by section 201 (d). (See § 29.201-8.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5110]

§ 29.207-6 *Amortization of premium and accrual of discount.* Section 207 (d) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 207. Such amortization and accrual is the same as that provided for life insurance companies by section 201 (e) and shall be determined in accordance with the regulations thereunder, see § 29.201-9, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 207 the basis provided in section 113 shall be used in lieu of the acquisition value.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5369, 9 F. R. 5110]

NONRESIDENT ALIEN INDIVIDUALS

§ 29.211-1 *Taxation of aliens in general.* For the purposes of chapter 1 alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident aliens are in general taxable the same as citizens of the United States, that is, a resident alien is taxable on income derived from all sources including sources without the United States. Nonresident aliens are taxable only on income from sources within the United States. For classification of nonresident aliens, see § 29.211-7.

§ 29.211-2 *Definition.* (a) A "nonresident alien individual" means an individual:

(1) Whose residence is not within the United States; and

(2) Who is not a citizen of the United States.

The term includes a nonresident alien fiduciary.

(b) An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

§ 29.211-3 *Alien seamen, when to be regarded as residents.* In order to determine whether an alien seaman is a resident within the meaning of chapter 1, it is necessary to decide whether the

presumption of nonresidence is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 29.211-4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence, because the head tax is payable unless the alien who is entering the country is merely in transit through the country.

§ 29.211-4 *Proof of residence of alien.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of chapter 1. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overcome:

(a) In the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (1) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (2) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (3) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident;

(b) In other cases by (1) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (2) proof that the alien has filed Form 1078 or its equivalent, or (3) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

In any case in which an alien seeks to overcome the presumption of nonresidence under paragraph (a) (3) or (b) (3) of this section, if the internal-revenue officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits.

§ 29.211-5 *Loss of residence by alien.* An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§ 29.211-6 *Duty of employer to determine status of alien employee.* If wages are paid to aliens without withholding the tax, except as permitted in § 29.143-3, in the case of a resident of Canada or Mexico, the employer should be prepared to prove the status of the alien as provided in §§ 29.211-1 to 29.211-5. An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078, or an equivalent certificate of the alien establishing residence. An employer need not secure Form 1078 from the alien if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he had not at the time secured Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent

evidence. The written statement of the alien employee may ordinarily be relied upon by the employer as proof that the alien is a resident of the United States.

§ 29.211-7 *Taxation of nonresident alien individuals.* For the purposes of this section and §§ 29.212-1, 29.213-1, 29.214-1, 29.215-1, and 29.217-2, nonresident alien individuals are divided into three classes: 1. Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States; 2. nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States; and 3. nonresident alien individuals who at any time during the taxable year are engaged in trade or business in the United States.

(a) *No United States business; general rule.* (1) A nonresident alien individual within class 1, referred to in the preceding paragraph, is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 211 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Internal Revenue Code as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see § 29.143-2. The items of fixed or determinable annual or periodical income from sources within the United States received before January 1, 1945, by a citizen of France residing in France which are exempt from Federal income taxation under the provisions of the tax convention and protocol between the United States and France, signed April 27, 1932, and effective January 1, 1936, or received on or after January 1, 1945, by a resident of France which are so exempt under the provisions of the tax convention and protocol between the United States and France, signed July 25, 1939, and effective January 1, 1945, are described in § 29.143-3. As to the items of such income received on or after January 1, 1940, by individual residents of Sweden or by Swedish corporations or other Swedish entities and exempt from Federal income taxation, see the tax convention between the United States and Sweden, effective January 1, 1940, and the regulations thereunder (see §§ 7.200 to 7.218 of this chapter). Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) certain annuities and pensions received on and after January 1, 1941, by individual residents of Canada are exempt from tax. As to items of income received in taxable years beginning on or after January 1, 1945, by individual residents of the United Kingdom, see Treasury Decision 5569, approved July 3, 1947 (Part 182 of this chapter).

(2) The fixed or determinable annual or periodical income from sources within the United States of a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States is taxable at the rate of 30 percent as to such income received on and after October 31, 1942 (27½ percent as to such income received before October 31, 1942), except that such rate shall be reduced, in the case of a resident of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, to such rate (not less than 5 percent) as may be provided by treaty with such country. (See also § 29.212-1.) Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) and effective January 1, 1941, the tax rates of 27½ percent or 30 percent, as the case may be, otherwise imposed by section 211 (a), were reduced to 15 percent as to items of income received on or after April 30, 1941, in the case of a nonresident alien individual who is a resident of Canada (see §§ 7.10 to 7.17 of this chapter).

(b) *No United States business; aggregate more than $15,400.* A nonresident alien individual within class 2, referred to in the introductory paragraph of this section, is under the provisions of section 211 (c), subject to tax only upon his fixed or determinable annual or periodical income specified in section 211 (a) determined under the provision of section 119, minus (1) the deductions properly allocable to such income and (2) the so-called "charitable contributions" deduction provided in section 213 (c). Such nonresident alien is entitled to the credits against net income allowable to an individual by section 25, subject to the limitations provided in section 214. However, the tax thus computed under sections 11 and 12 shall in no such case be less than 30 percent (27½ per cent prior to October 31, 1942) of the gross amount of such fixed or determinable annual or periodical income from sources within the United States. Nonresident aliens within class 2 (other than residents of Canada) are also subject to the victory tax imposed by section 450. A nonresident alien, a resident of Canada, within class 2 is not subject to the provisions of section 211 (c) of this section but is subject to taxation as set forth in paragraph (a) of this section regardless of the amount of his fixed or determinable annual or periodical income from sources within the United States (see §§ 7.10 to 7.17 of this chapter).

(c) *United States business.* (1) A nonresident alien individual within class 3 referred to in the introductory paragraph of this section, is not taxable at the rate of 30 percent (27½ percent prior to October 31, 1942) upon the items of gross income enumerated in section 211 (a). The net income from sources within the United States of such a nonresident alien individual (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 213) less the credits against net income allowable to an individual by section 25, is subject to the normal tax, the surtax, and, for taxable years beginning in 1493, the victory tax.

(2) As used in sections 119, 143, 144, 211, and 231, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year but does not include the performance of personal services for a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian. (See also § 29.212-1.) The term "commodities" as used in section 211 (b) means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce.

(3) Neither the beneficiary nor the grantor of a trust, whether revocable or irrevocable, is deemed to be engaged in trade or business in the United States merely because the trustee is engaged in trade or business in the United States.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 19, T. D. 5443, 10 F. R. 2496, T. D. 5580, 12 F. R. 7826]

§ 29.212-1 *Gross income of nonresident alien individuals*—(a) *General.* (1) In general, in the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 119. (See §§ 29.119-1 to 29.119-14.) The items of gross income from sources without the United States, and therefore not taxable to nonresident aliens are described in section 119 (c). As to who are nonresident alien individuals, see §§ 29.211-2 to 29.211-6.

(a) Income received by a resident alien from sources without the United States is taxable although such person may become a nonresident alien subsequent to its receipt and prior to the close of the taxable year. Conversely, income received by a nonresident alien from sources without the United States is not taxable though such person may become a resident alien subsequent to its receipt and prior to the close of the taxable year.

(b) *No United States business.* The gross income of a nonresident alien individual not engaged in trade or business within the United States at any

time during the taxable year, whether such alien comes within section 211 (a) or section 211 (c), is gross income from sources within the United States consisting of fixed or determinable annual or periodical income. His taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(c) *United States business.* (1) The gross income of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States is not limited to the items of gross income specified in section 211 (a), but includes any item of gross income which is treated as income from sources within the United States, except those items which are exempt from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See sections 22 (b), 112, 116, 119, and 212 (b).)

(2) 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, the surtax and, for taxable years beginning in 1943, the victory tax. However, the phrase "engaged in trade or business within the United States" does not apply to the personal services performed within the United States for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such compensation is not income from sources within the United States. (See section 119 (a) (3).) As to the exclusion from gross income of the official compensation received by employees of foreign governments or of international organizations, see section 116 (h).

(3) The effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian does not bring a nonresident alien individual within the class of nonresident alien individuals engaged in trade or business within the United States, but if a nonresident alien individual by reason of rendering personal services in the United States, or for other reasons, is classed as a nonresident alien individual engaged in trade or business within the United States, he is taxable upon all income from sources within the United States, including profits derived from the effecting of such transactions. Such a nonresident alien individual is required to include in gross income capital gains, gains from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein. The term "commodities" as used in section 211 (b) means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 19, T. D. 5600, 13 F. R. 577]

§ 29.212-2 *Exclusion of earnings of foreign ships or aircraft from gross income*—(a) *Ships under foreign flag.* (1) So much of the income from sources within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in such foreign country and to corporations organized in the United States, shall not be included in gross income. Foreign countries which either impose no income tax, or, in imposing such tax, exempt from taxation so much of the income of a citizen of the United States nonresident in such foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States are considered as granting an equivalent exemption within the meaning of this paragraph.

(2) A nonresident alien individual not engaged in trade or business within the United States at any time within the taxable year is not required to include in gross income such income from sources within the United States as is derived from the operation of a ship or ships, whether or not the foreign country under the laws of which such ships are documented meets the equivalent exemption requirement of the Internal Revenue Code.

(b) *Aircraft of foreign registry.* (1) For taxable years beginning after December 31, 1945, so much of the income from sources within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States as consists of earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in such foreign country and to corporations organized in the United States, shall not be included in gross income. Foreign countries which either impose no income tax, or, in imposing such tax, exempt from taxation so much of the income of a citizen of the United States nonresident in such foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States are considered as granting an equivalent exemption within the meaning of this paragraph.

(2) A nonresident alien individual not engaged in trade or business within the United States at any time within the taxable year is not required to include in gross income such income from sources within the United States as is derived from the operation of aircraft, whether or not the foreign country under the laws of which such aircraft are registered meets the equivalent exemption requirement of the Internal Revenue Code.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5667, 13 F. R. 6761]

§ 29.213-1 *Deductions allowed nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is not allowed any deductions, the tax being imposed upon the amount of gross income received.

(2) *Aggregate more than $15,400.* A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year and deriving for such year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States is allowed for such year only such deductions as are properly allocable to such income. He is also allowed the contributions or gifts made within the taxable year whether or not connected with income from sources within the United States but only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject to the limitations provided in section 23 (o).

(b) *United States business.* (1) In the case of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. (See also section 215.) In the case of such taxpayers, however, (i) losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, although not connected with the trade or business, are (if otherwise allowable) deductible only if and to the extent that the profit, if such transaction had resulted in a profit, would have been taxable as income from sources within the United States; (ii) losses sustained during the taxable year of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise, are deductible only if the property was located within the United States; and (iii) contributions or gifts made within the taxable year are deductible, only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 23 (o), or to the vocational rehabilitation fund, subject

to the limitation provided in section 23 (o).

(2) Losses embraced under paragraph (a) (2) of this section are deductible in full from items of gross income specified as being derived in full from sources within the United States, and, if greater than the sum of such items, the unabsorbed loss may be deducted from the income apportioned to sources within the United States under the provisions of § 29.119-12. Losses embraced under paragraph (a) (1) of this section are deductible in full (as provided in § 29.119-10 or § 29.119-11) when the profit from the transaction, if it had resulted in a profit, would have been taxable in full as income from sources within the United States, but should be deducted under the provisions of § 29.119-12 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

§ 29.214-1 *Credits to nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business in the United States at any time during the taxable year is not allowed any credits under section 25, the tax being imposed upon the amount of gross income received.

(2) *Aggregate more than $15,400.* In the case of a nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year and deriving in such year gross amount of fixed or determinable annual or periodical income from sources within the United States or more than $15,400, the credits allowed are those applicable in the case of nonresident alien individuals engaged in trade or business within the United States.

(b) *United States business*—(1) *Taxable years beginning before January 1, 1944.* For taxable years beginning before January 1, 1944, in the case of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States, the personal exemption allowed as a credit against net income by section 25 (b) (1) shall, except in the case of a resident of a contiguous country, be $500, whether such alien is a single person, a married person living with husband or wife, or the head of a family. However, in the case of a resident of Canada or Mexico the same personal exemption as in the case of a citizen of the United States applies on the basis of reciprocity. If, therefore, it is established to the satisfaction of the Commissioner that the individual is married and living with husband or wife or is the head of a family, as the case may be, the personal exemption pertaining to such status will be applicable provided that the country of which the individual is a resident, allows a citizen of the United States not residing in such country, and who is married and living with husband or wife or is the head of a family, the same personal exemption as is allowed by such country to its own citizens who occupy such status. The credit for dependents provided by section 25 (b) (2) is allowed to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States only if they are residents of Canada or Mexico. If the status of the taxpayer as to dependents changes during the taxable year, the credit for dependents shall be determined as provided in § 29.25-7.

(2) *Taxable years beginning after December 31, 1943.* In the case of a nonresident alien individual (except a resident of Canada or Mexico) who at any time during the taxable year was engaged in trade or business within the United States, the normal tax exemption allowed as a credit against net income by section 25 (a) (3) and the surtax exemption allowed as a credit against net income by section 25 (b) shall, for taxable years beginning after December 31, 1943, and before January 1, 1946, each be $500; and, for taxable years beginning after December 31, 1945, only one exemption under section 25 (b) for both normal tax and surtax purposes shall be allowed. In the case of a resident of Canada or Mexico, the same normal-tax exemption, surtax exemptions, and exemptions under section 25 (b) for both normal tax and surtax, as in the case of a citizen of the United States, shall apply.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 19, T. D. 5517, 11 F. R. 6535]

§ 29.215-1 *Allowance of deductions and credits to nonresident alien individuals*—(a) *No United States business*—(1) *General rule.* In general, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is not entitled to any allowance of

deductions or credits even though he may file a return of income.

(2) *Aggregate more than $15,400.* Unless a nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year and having, for such year from sources within the United States, fixed or determinable annual or periodical income in a gross amount of more than $15,400 shall file or cause to be filed with the collector a true and accurate return of his total fixed or determinable annual or periodical income from sources within the United States as required by paragraph (a) (2) of § 29.217-2, the tax shall be collected on the basis of gross amount of such fixed or determinable annual or periodical income. Where such nonresident alien has various sources of fixed or determinable annual or periodical income from within the United States, as, for instance, from an estate or trust, from stocks or bonds held directly by him, or from securities held for him by a custodian resident in the United States, so that his total gross fixed or determinable annual or periodical income from United States sources is in excess of $15,400 and a return of income is not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the fixed or determinable annual or periodical income from all sources within the United States concerning which he has information without allowance for deductions and credits, and will assess the tax and collect it from one or more of the sources of income within the United States. Such nonresident alien shall make or have made a full and accurate return on Form 1040NB-a of all his fixed or determinable annual or periodical income from sources within the United States. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (b) of § 29.217-2, which is hereby made equally applicable in the case of a nonresident alien individual coming within the provisions of this paragraph.

(b) *United States business.* Unless a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States shall file, or cause to be filed, with the collector, a true and accurate return of his total income from sources within the United States, as required by paragraph (b) of § 29.217-2, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a nonresident alien has various sources of income within the United States, so that his total income calls for the assessment of a surtax, and a return of income was not filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the income of such nonresident alien from all sources concerning which he has information, without allowance for deductions or credits, and will assess the tax and collect it from one or more of the sources of income of such nonresident alien within the United States.

§ 29.217-1 *Time and place of filing returns of nonresident alien individuals.* (a) The return in the case of a nonresident alien individual (but, as to taxable years beginning after December 31, 1942, only such individuals who do not have wages subject to withholding at the source under section 1622) must be made on or before the 15th day of the sixth full calendar month following the close of the taxable year, except that the return for a fractional part of a year ending prior to January 1, 1944, must be filed on or before June 15, 1944. In the case of any return for a fractional part of a year the Commissioner may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return, but such time shall not be later than the 15th day of the 18th full calendar month ending after the beginning of the fractional part of the year. For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter. The return must be filed with the collector of internal revenue for the district in which the nonresident alien individual has his principal place of business in the United States, or if he has no principal place of business in the United States, then with the collector of internal revenue at Baltimore, Md. For failure to make and file return within the time prescribed, see section 291. For cases in which no return is required, see paragraph (a) of § 29.217-2.

(b) In the case of nonresident alien individuals who have wages subject to withholding under section 1622, the general rule provided in the first paragraph

of this section with respect to the filing of the return has no application to taxable years beginning after December 31, 1942. Such latter aliens are required to file their returns and to pay the tax for such taxable years at the time prescribed generally for United States citizens and residents. Such aliens having been placed upon a current tax payment system applicable generally to United States citizens and residents, the provisions relative to the filing of returns and payment of tax in the case of such citizens and residents are equally applicable to such aliens. As to the time of filing the return in the case of United States citizens and residents, see section 53 and § 29.53-1.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5305, 8 F. R. 15559, T. D. 5339, 9 F R. 2772]

§ 29.217-2 *Return of income*—(a) *No United States business*—(1) *General rule.* If the tax liability of a nonresident alien individual, not engaged in trade or business within the United States at any time during the taxable year, is fully satisfied at the source a return of income is not required. A nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year shall make or have made a return on Form 1040NB with respect to that portion of his income received from sources within the United States consisting of interest on so-called tax-free covenant bonds on which a tax of only 2 percent was withheld at the source, and with respect to any other fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(2) *Aggregate more than $15,400.* A nonresident alien individual (other than a resident of Canada) not engaged in trade or business within the United States at any time during the taxable year deriving in such year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States, shall make or have made a full and accurate return on Form 1040NB-a of all his fixed or determinable annual or periodical income from sources within the United States. Such return need not disclose profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein. As to the duty of the representative or agent of such alien to file the return and pay the tax, see paragraph (b) of this section, which is hereby made equally applicable in the case of a nonresident alien coming within the provisions of this paragraph.

(b) *United States business.* (1) If a nonresident alien individual at any time within the taxable year is engaged in trade or business within the United States, he shall make or have made a full and accurate return on Form 1040B of his income received from all sources within the United States. A return will not be required, however, in the case of such a nonresident alien individual, a resident of Canada or Mexico, whose sole income from sources within the United States consists of compensation for personal services and does not exceed $500 during the taxable year.

(2) The responsible representative or agent within the United States of a nonresident alien individual who at any time within the taxable year was engaged in trade or business within the United States shall make in behalf of his nonresident alien principal, a return of, and shall pay the tax on, all income from sources within the United States coming within his control as representative or agent. The agency appointed will determine how completely the agent is substituted for the principal for tax purposes. See § 29.51-2. Any person who collects interest or dividends on deposited securites of such a nonresident alien, executes ownership certificates in connection therewith and sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the nonresident alien. Where upon filing a return of income it appears that such a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. (See § 29.143-4.)

§ 29.218-1 *Date on which tax shall be paid by nonresident alien individual.* In the case of a nonresident alien individual (but, as to taxable years beginning after December 31, 1942, only such individuals who do not have wages subject to withholding under section 1622) the tax shall be paid on or before the date prescribed by the Internal Revenue Code and the regulations thereunder for filing of the return, without regard to any extension of time granted for the filing of the return under authority of section 53. See § 29.217-1. As to payment of the tax in installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax or an installment thereof is postponed by reason of the war, see Part 472 of this chapter. In the case of a nonresident alien individual who has wages subject to withholding at the source under the provisions of section 1622 the tax for taxable years beginning after December 31, 1942, is to be paid at the time provided in the case of United States citizens and residents. See § 29.56-1.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5305, 8 F. R. 15560, T. D. 5339, 9 F. R. 2772]

§ 29.219-1 *Partnerships.* Whether a nonresident alien individual who is a member of a partnership is taxable under the provisions of (A) section 211 (a) or 211 (c) or (B) section 211 (b) may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 211 (a) or 211 (c), as the case may be, depending on whether in the taxable year he derives fixed or determinable annual or periodical income from sources within the United States of more than $15,400, if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 211 (b). For definition of what the term "partnership" includes, see section 3797 (a) (2). The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. (See § 29.211-7.)

FOREIGN CORPORATIONS

§ 29.231-1 *Taxation of foreign corporations.* For the purposes of this section and §§ 29.231-2, 29.232-1, 29.235-1, 29.235-2 and 29.236-1, foreign corporations are divided into two classes: (1) foreign corporations not engaged in trade or business within the United States at any time within the taxable year, referred to in the regulations as nonresident foreign corporations (see § 29.3797-8); and (2) foreign corporations which at any time within the taxable year are engaged in trade or business within the United States, referred to in the regulations as resident foreign corporations (see § 29.3797-8).

(a) *Nonresident foreign corporations.* (1) A nonresident foreign corporation is liable to the tax upon the amount received from sources within the United States, determined under the provisions of section 119, which is fixed or determinable annual or periodical gains, profits, and income. For the purposes of section 231 (a), the term "amount received" means "gross income." Specific items of fixed or determinable annual or periodical income are enumerated in the Internal Revenue Code as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax, as, for instance, royalties. As to the definition of fixed or determinable annual or periodical income, see § 29.143-2. The items of fixed or determinable annual or periodical income from sources within the United States received before January 1, 1945, by a corporation organized under the laws of France, which are exempt from Federal income tax under the provisions of the tax convention and protocol between the United States and France, signed April 27, 1932, and effective January 1, 1936 (see paragraph 108 of the Appendix to this part), or received on or after January 1, 1945, by a corporation or other entity organized under the laws of France, which are so exempt under the provisions of the tax convention and protocol between the United States and

France, signed July 25, 1939, and effective January 1, 1945, are described in § 29.143–3. As to items of such income received on or after January 1, 1940, by Swedish corporations and exempt from Federal income taxation, see the tax convention between the United States and Sweden, effective January 1, 1940, and regulations thereunder (see §§ 7.200 to 7.218 of this chapter). Under the provisions of the tax convention between the United States and Canada (ratifications exchanged June 15, 1942) the tax rates of 27½ percent or 30 percent, as the case may be, otherwise imposed by section 231 (a) are reduced to 15 percent as to items of income in the case of such corporations organized under the laws of Canada. As to items of income received in taxable years beginning on or after January 1, 1945, by foreign corporations managed and controlled in the United Kingdom and not having a permanent establishment in the United States, see Treasury Decision 5569, approved July 3, 1947 (Part 182 of this chapter).

(2) The fixed or determinable annual or periodical income from sources within the United States, including royalties, of a nonresident foreign corporation is taxable at the rate of 30 percent (27½ percent as to such income received prior to October 31, 1942). In the case of dividends received by a nonresident foreign corporation organized under the laws of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, the rate shall be reduced to such rate (not less than 5 percent) as may be provided by treaty with such country.

(b) *Resident foreign corporations.* (1) A resident foreign corporation is not taxable upon the items of fixed or determinable annual or periodical income enumerated in section 231 (a) at the rate specified in that section. A resident foreign corporation is, under section 14 (c) (1), liable to a tax of 24 percent of its normal-tax net income (regardless of the amount thereof), that is, its net income from sources within the United States (gross income from sources within the United States minus the statutory deductions provided in sections 23 and 232) less the credits allowed against net income by section 26 (a) and (b). A resident foreign corporation is also liable to the corporation surtax at the following rates:

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

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

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

The corporation surtax net income of a resident foreign corporation is its net income from sources within the United States less the credit allowed by section 26 (b), which credit is limited in amount to 85 percent of its net income from sources within the United States.

(2) As used in sections 119, 143, 144, 211, and 231, the phrase "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. Such phrase does not include the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian. The term "commodities" as used in section 211 (b) means only goods of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, and does not include merchandise in the ordinary channels of commerce.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5443, 10 F. R. 2496, T. D. 5580, 12 F. R. 7826]

§ 29.231–2 *Gross income of foreign corporations.* In the case of a foreign corporation, including a life insurance company not carrying on an insurance business within the United States and holding no reserve funds upon business transacted within the United States (see section 201 (b) (3)), an insurance company other than life or mutual not carrying on an insurance business within the United States (see section 204 (a) (3)), and a mutual insurance company other than life not carrying on an insurance business within the United States (see section 207 (a)), the term "gross income" means gross income from sources within the United States as defined and described in section 119. (See §§ 29.119–1 to 29.119–14.) The items of gross income from sources without the United States and therefore not taxable

to foreign corporations are described in section 119 (c). As to the definition of a foreign corporation see section 3797 (a) (3) and (5). As to foreign life insurance companies, see § 29.201 (b)-2. As to foreign corporations formed or availed of to avoid surtax, see § 29.102-4. As to personal holding companies organized under the laws of foreign countries, see § 29.505-1. As to foreign personal holding companies, see sections 331 to 340, and §§ 29.331-1 to 29.339-3.

(a) *Nonresident foreign corporations.* A nonresident foreign corporation is taxable under section 231 (a) only on fixed or determinable annual or periodical gross income received from sources within the United States. Its taxable income does not include profits derived from the effecting of transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian, or profits derived from the sale within the United States of personal property or real property located therein.

(b) *Resident foreign corporations.* (1) The gross income from sources within the United States of a resident foreign corporation is not limited to the items of fixed or determinable annual or periodical income referred to in section 231 (a), but includes every item of gross income which is treated as income from sources within the United States, except those items which are specifically exempt from taxation by statute or treaty or which are not taxable by the Federal Government under the Constitution. (See section 22 (b), 119, and 231 (d).)

(2) A foreign corporation which effects transactions in the United States in stocks, securities, or commodities (including hedging transactions) through a resident broker, commission agent, or custodian is not merely by reason of such transactions considered as being engaged in trade or business within the United States which would cause it to be classed as a resident foreign corporation. However, a foreign corporation which at any time within the taxable year is otherwise engaged in trade or business in the United States, being a resident foreign corporation, is taxable upon all income derived from sources within the United States, including the profits realized from such transactions. A resident foreign corporation is also required to include in its gross income capital gains, gains from hedging transactions, and profits derived from the sale within the United States of personal property, or of real property located therein.

§ 29.231-3 *Exclusion of earnings of foreign ships or aircraft from gross income.* (a) A resident foreign corporation may exclude from gross income under section 231 (d) so much of its income from sources within the United States as consists of earnings derived from the operation of a ship or ships documented or aircraft registered under the laws of a foreign country, to the same extent as provided in § 29.212-2 with respect to nonresident alien individuals.

(b) A nonresident foreign corporation is not required to include in gross income such income from sources within the United States as is derived from the operation of a ship or ships or aircraft, whether or not the foreign country under the laws of which such ships are documented or aircraft registered meets the equivalent exemption requirements of the statute.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5667, 13 F. R. 6761]

§ 29.232-1 *Deductions allowed foreign corporations*—(a) *Nonresident foreign corporations.* A nonresident foreign corporation is not allowed any deductions from gross income from sources within the United States, the tax being imposed upon the amount of gross income received. (See § 29.231-1.)

(b) *Resident foreign corporations.* A resident foreign corporation is allowed the same deductions from its gross income arising from sources within the United States as are allowed a domestic corporation under section 23 to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction allowed by section 23 (q) is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119. As to foreign life insurance companies, see § 29.201-2. As to foreign corporations formed or availed of to avoid surtax, see § 20.102-4. As to personal holding companies organized under the laws of foreign countries, see § 29.505-1. As to foreign personal holding companies, see sections 331 to 340, and §§ 29.331-1 to 29.339-3.

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§ 29.233-1 *Allowance of deductions and credits.* The benefit of the deductions and credits allowed a resident foreign corporation can be had only by filing or causing to be filed with the collector a true and accurate return of its total income received from sources within the United States. Only items of interest and dividends included in gross income may be credited under section 26 (a) and (b). Inasmuch as a nonresident foreign corporation is taxable under section 231 (a) only upon fixed or determinable annual or periodical gross income received from sources within the United States, such foreign corporation may not receive the benefit of the deductions and credits by filing a return of income.

§ 29.235-1 *Time and place for filing returns of foreign corporations*—(a) *Nonresident foreign corporations.* The return in the case of a nonresident foreign corporation shall be made on or before the 15th day of the sixth full calendar month following the close of the taxable year, except that the return for a fractional part of a year ending prior to January 1, 1944, shall be made on or before June 15, 1944. In the case of any return for a fractional part of a year the Commissioner may, upon a showing by the taxpayer of unusual circumstances, prescribe a later time for the filing of the return, but such time shall not be later than the 15th day of the 18th full calendar month ending after the beginning of the fractional part of the year. If a nonresident foreign corporation has an agent in the United States, the return shall be made by the agent. The return must be filed with the collector of internal revenue, Baltimore, Md. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed, see section 291. For cases in which no return is required, see § 29.235-2 (a). For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter.

(b) *Resident foreign corporations.* The return in the case of a resident foreign corporation, in lieu of the time prescribed in section 235, shall be made on or before the 15th day of the third month following the close of the fiscal year, or on or before the 15th day of March if on the basis of the calendar year. (See section 53 (a) (1).) If the return is for a fractional part of a year, it shall be filed at the time prescribed in § 29.53-1. The return must be filed with the collector of internal revenue for the district in which the resident foreign corporation has its principal place of business or principal office or agency in the United States. (See section 53 (b) (2).) For failure to make and file a return within the time prescribed, see section 291. For provisions relating to certain cases in which the time for filing the return is postponed by reason of the war, see Part 472 of this chapter.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5339, 9 F. R. 2772]

§ 29.235-2 *Return of income*—(a) *Nonresident foreign corporations.* If the tax liability of a nonresident foreign corporation is fully satisfied at the source a return of income is not required. A nonresident foreign corporation shall make or have made a return on Form 1120NB with respect to that portion of its income received from sources within the United States consisting of interest on so-called tax-free covenant bonds on which a tax of only 2 percent was withheld at the source, and with respect to any other fixed or determinable annual or periodical income upon which the tax was not fully satisfied at the source, including dividends received from a foreign corporation which are treated as income from sources within the United States under section 119 (a) (2) (B), and shall pay the balance of the tax shown to be due.

(b) *Resident foreign corporations.* If a foreign corporation at any time within the taxable year is a resident corporation it shall make a full and accurate return on Form 1120 of its income received from sources within the United States.

§ 29.236-1 *Dates on which tax shall be paid by foreign corporations*—(a) *Nonresident foreign corporations.* In the case of a nonresident foreign corporation the total amount of tax imposed by chapter 1 shall be paid on or before the date prescribed by the Internal Revenue Code and the regulations thereunder for filing of the return, without regard to any extension of time granted for the filing of the return under authority of section 53. See § 29.235-1. As to payment of the tax installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax

or an installment thereof is postponed by reason of the war, see Part 472 of this chapter.

(b) *Resident foreign corporations.* In the case of a resident foreign corporation the total amount of tax imposed by chapter 1 shall be paid, in lieu of the time prescribed in section 236 (a), on the 15th day of March following the close of the calendar year, or if the return is made on the basis of a fiscal year, then on the 15th day of the third month, following the close of the fiscal year. If the return is made for a fractional part of a year, the tax shall be paid at the time prescribed in § 29.56-1. As to payment of the tax in installments, see § 29.56-1. For provisions relating to certain cases in which the date otherwise prescribed for the payment of the tax on an installment thereof is postponed by reason of the war, see Part 472 of this chapter.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5339, 9 F. R. 2772, T. D. 5458, 10 F. R. 7335]

POSSESSIONS OF THE UNITED STATES

§ 29.251-1 *Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States.* (a) In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States:

(1) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(2) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 251) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, although such citizen was actively engaged in the management of such corporation, does not represent income derived from the active conduct of a trade or business within the possession of the United States, either on the taxpayer's own account or as an employee or agent of another.

(b) A citizen of the United States who on account of the nature and amount of his income cannot meet the 80 percent and the 50 percent requirements of the Internal Revenue Code, but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 116 (a): *Provided,* That (1) he is, with respect to taxable years beginning prior to January 1, 1943, away from the United States for more than six months of the taxable year, or is, with respect to taxable years beginning after December 31, 1942, a bona fide resident of a foreign country or countries during the entire taxable year, and (2) he does not receive his earned income from the United States or any agency thereof. In such a case none of the provisions of section 251 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 25 (a) (4).

(c) In the case of a husband and wife making a joint return, the term "gross income," as used in this section, means the combined gross income of the spouses.

(d) For a determination of the income from sources within the United States, see section 119. A citizen entitled to the benefits of section 251 is required to file with his individual return Form 1040 or 1040A, the schedule on Form 1040E. If a citizen entitled to the benefits of section 251 has no income from sources within the United States or does not receive within the United States any income whether derived from sources within or without the United States, he is not required to file a return or the schedule on Form 1040E.

(e) A citizen of the United States who was taken prisoner of war while serving within a possession of the United States as a member of the military or naval forces of the United States, or who was

interned by the enemy while serving as an employee (whether the employment is governmental or private) within a possession of the United States is not to be deprived of the benefits of section 251, if otherwise qualified for such benefits, even though his subsequent place or places of confinement by the enemy were not within a possession of the United States.

Example. On July 1, 1942, A, who is a citizen of the United States, went to Puerto Rico and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1942 of some Puerto Rican real estate not connected with his trade or business. In the first six months of 1942 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1942. Inasmuch as for the applicable part (July 1, 1942, to December 31, 1942) of the 3-year period immediately preceding the close of the taxable year (the calendar year 1942), 80 percent of A's gross income ($32,000, or 80 percent of $40,000) was derived from sources within a possession of the United States and as 50 percent or more of his gross income ($20,000, or 50 percent of $40,000) for such part of the 3-year period was derived from the active conduct of a trade or business within a possession of the United States, he is required to report in gross income in his return for 1942 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5645, 13 F. R. 4258]

§ 29.251-2 *Income received within the United States.* Notwithstanding the provisions of section 251 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example given in § 29.251-1, the taxpayer during the latter part of 1942 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the Puerto Rican real estate, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 251 with respect to other items of gross income excluded by that section.

§ 29.251-3 *Tax in case of corporations.* A domestic corporation entitled to the benefits of section 251 is, under section 251 (c) (1), subject to the tax imposed by section 13 if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b) if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a corporation is also subject to the surtax imposed by section 15 (see § 29.15-1).

§ 29.251-4 *Definition.* The term "United States" as used in §§ 29.251-1 to 29.252-1 includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia. The term "possession of the United States," as used in sections 251 and 252 and § 29.251-1, this section, and § 29.252-1, includes Puerto Rico, the Philippine Islands prior to July 4, 1946, the Panama Canal Zone, Guam, American Samoa, Wake, and the Midway Islands; it does not include the Virgin Islands. Prior to July 4, 1946, the Philippine Islands came within the classification of "possessions of the United States" for Federal income tax purposes, notwithstanding the establishment of the Commonwealth of the Philippines under the Act of March 24, 1934 (48 Stat. 456). The Philippine Islands on July 4, 1946, became a separate self-governing nation.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5534, 11 F. R. 9553]

§ 29.251-5 *Deductions allowed citizens and domestic corporations entitled to the benefits of section 251.* In the case of a citizen entitled to the benefits of section 251, the deductions allowed by section 23 for business expenses, interest, taxes, losses in trade, bad debts, depreciation, and depletion are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of § 29.213-1 relating to the allowance to nonresident alien individuals who at any time within the taxable year were engaged in trade or business within the United States, of the deductions provided in section 23 (e) (2) and (3) for losses not connected with the trade or business are applicable in the case of citizens entitled to the benefits of section 251. The provisions of § 29.213-1 pertaining

to the allowance to such nonresident alien individuals of deductions for contributions provided in section 23 (o) are also applicable in the case of such citizens. Corporations entitled to the benefits of section 251 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction allowed by section 23 (q) is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 119.

§ 29.251-6 *Allowance of deductions and credits to citizens and domestic corporations entitled to the benefits of section 251.* Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 251 shall file or cause to be filed with the collector a true and accurate return of total income from sources within the United States, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where such a citizen or corporation has various sources of income within the United States so that the total income calls for the assessment of a tax, and a return of income was not filed by or on behalf of the citizen or corporation, the Commissioner will cause a return of income to be made and include therein the income of such citizen or corporation from all sources concerning which he has information, and will assess the tax and collect it from one or more of the sources of income of such citizen or corporation within the United States without allowance for deductions or credits.

§ 29.252-1 *Status of citizens of United States possessions.* (a) A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. (See sections 211 to 219.) For Federal income tax purposes a citizen of a possession of the United States who is not otherwise a citizen of the United States is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. (See section 143.)

(b) For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (1) citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States and (2) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States. The provisions of §§ 29.211-7 to 29.219-1 applicable to nonresident alien individuals not engaged in trade or business within the United States, are applicable to the citizens of possessions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(c) The act referred to in section 252 (b) provides that income tax laws then or thereafter in force in the United States shall apply to the Virgin Islands, but that the taxes shall be paid into the treasury of the Virgin Islands. Accordingly, persons are taxed there under the income tax provisions of the Internal Revenue Code.

CHINA TRADE ACT CORPORATIONS

§ 29.261-1 *Tax on China Trade Act corporations.* A China Trade Act corporation is, under section 261 (a), subject to the tax imposed by section 13 (b) if it has a normal-tax net income of more than $25,000 (see § 29.13-1), or to the tax provided by section 14 (b) if it has a normal-tax net income of not more than $25,000 (see § 29.14-1). Such a corporation is also subject to the surtax imposed by section 15 (see § 29.15-1).

§ 29.262-1 *Income of China Trade Act corporations.* The items of gross income to be included in the return of a corporation organized under the China Trade Act and the deductions allowable

are the same as in the case of other domestic corporations.

§ 29.262-2 *Credits allowed China Trade Act corporations.* (a) In addition to the credits allowed under section 26 (a) and (b), a China Trade Act corporation is, under certain conditions, allowed an additional credit for the purpose of computing the taxes imposed by section 13 or 14, by section 15, and by section 600. This credit is an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 119) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease in the tax imposed by section 13 or 14, and section 15, by reason of such credit must not, however, exceed the amount of the special dividend referred to in section 262 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce. The decrease in the tax imposed by section 600 by reason of such credit must not exceed the amount by which such special dividend exceeds the decrease permitted by section 262 in the tax imposed by section 13 or 14, and section 15. A China Trade Act corporation is not entitled to the credit for taxes paid to foreign countries and possessions of the United States allowed to domestic corporations under the provisions of section 131.

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

Example. The A Company, a China Trade Act corporation, has a net income for the calendar year 1942 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1942, is owned on that date by persons resident in China, the United States, or possessions of the United States, or individual citizens of the United States or China. The declared value of the capital stock of the corporation shown on its capital stock tax return for the capital stock tax year ended June 30, 1942, is $1,500,000. It distributes a special dividend amounting to $85,000 on February 15, 1943, which is certified by the Secretary of Commerce as provided in section 262 (b).

For the purpose of the tax imposed by section 13, it is necessary in this example to make two computations, first, without allowing the special credit against net income on account of income derived from sources within China, and, second, allowing such credit. The computations are as follows:

FIRST COMPUTATION—WITHOUT ALLOWING THE SPECIAL CREDIT AGAINST NET INCOME

Net income subject to tax	$200,000
Normal-tax net income	200,000
Normal tax (section 13)	48,000
Surtax net income	200,000
Surtax (section 15)	32,000
Total income tax	80,000

SECOND COMPUTATION—ALLOWING SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States and (2) individual citizens of the United States or China wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible as a special credit against net income.	
Special credit against net income	200,000
Amount of income subject to tax under section 13	None

Since the special dividend ($85,000) exceeds the diminution of the tax ($80,000) on account of the allowance of the special credit against net income, the entire amount of the special credit is allowable and the corporation has no income tax liability for 1942.

For the purpose of the declared value excess-profits tax it is also necessary to make two computations, first, without allowing the special credit against net income, and, second, allowing such credit. The computations are as follows:

FIRST COMPUTATION—WITHOUT ALLOWING THE SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Less: 10 percent of the value declared in the capital stock tax return for the capital stock tax year ended June 30, 1942 (10 percent of $1,500,000)	150,000
Net income subject to declared value excess-profits tax	50,000

Less: Amount taxable at 6$\frac{6}{10}$ percent, portion of net income in excess of 10 percent and not in excess of 15 percent of the declared value of the capital stock ($200,000 minus $150,000)	$50,000
Amount taxable at 13$\frac{2}{10}$ percent	None
Declared value excess-profits tax at 6$\frac{6}{10}$ percent (6$\frac{6}{10}$ percent of $50,000)	3,300

SECOND COMPUTATION—ALLOWING SPECIAL CREDIT AGAINST NET INCOME

Net income	$200,000
Since the total net income is derived from sources within China and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China whereever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of the net income from sources within China is deductible from net income	200,000
Amount of income subject to declared value excess-profits tax	None

Since the diminution of the declared value excess-profits tax ($3,300) on account of the special credit against net income does not exceed the amount by which the special dividend ($85,000) exceeds the diminution of the income tax ($80,000) on account of such credit, the entire amount of the special credit ($200,000) is allowable and the corporation has no declared value excess-profits tax liability for 1942.

§ 29.262-3 *Meaning of terms used in connection with China Trade Act corporations.* (a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922.

(b) The term "China" means (1) China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, (2) the Crown Colony of Hong Kong, and (3) the Province of Macao.

(c) The term "special dividend" means the amount which, during the year ending on the date fixed by law for the filing of the corporation's return, is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation. The time fixed by law for filing the return includes the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(d) For the purposes of section 262 the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(e) "Net income derived from sources within China" is the sum of the net income from sources wholly within China and that portion of the net income from sources partly within and partly without China which may be allocated to sources within China. The method of computing this income is similar to that described in section 119.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5424, 9 F. R. 15039]

§ 29.262-4 *Withholding by a China Trade Act corporation.* Dividends distributed by a corporation organized under the China Trade Act, 1922, which are treated as income from sources within the United States under the provisions of section 119 of the Internal Revenue Code are subject to withholding at the rate of 30 percent (27½ percent prior to October 31, 1942) when paid to persons (other than residents of China) who are (a) nonresident aliens, (b) nonresident partnerships composed in whole or in part of nonresident aliens, or (c) nonresident foreign corporations. The 30 percent (27½ percent prior to October 31, 1942) rate of withholding specified in this section with respect to dividends shall be reduced in the case of shareholders who are (1) nonresident aliens residents of any country in North, Central, or South America, or in the West Indies, or of Newfoundland, or (2) nonresident foreign corporations organized under the laws of any such country, to such rate (not less than 5 percent) as may be provided by treaty with such country. As to reduction in rate of withholding (i) in the case of nonresident alien individuals who are residents of Canada or Sweden, see § 29.143-1; (ii) in the case of corporations or other entities created or organized under the laws of Canada or Sweden, see § 29.144-1.

ASSESSMENT AND COLLECTION OF DEFICIENCIES

§ 29.271-1 *Deficiency defined*—(a) *Taxable years beginning prior to January 1, 1943.* (1) In defining the term "deficiency" for taxable years beginning prior to January 1, 1943, the Internal Revenue Code recognizes two classes of cases—one, where the taxpayer makes a return showing some tax liability; the other, where the taxpayer makes a return showing no tax liability, or where the taxpayer fails to make a return. Additional tax shown on an "amended return," so-called, filed after the due date of the return for the taxable year, is a deficiency within the meaning of the Code.

(2) When a case is considered for the first time, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount shown as the tax by the taxpayer on his return, or, if it is a case where no tax was reported by the taxpayer, the deficiency is the amount determined to be the correct amount of the tax. Subsequent information sometimes discloses that the amount previously determined to be the correct amount of the tax is less than the correct amount, and that a redetermination of the tax is necessary. In such a case the deficiency on redetermination is the excess of the amount determined to be the correct amount of the tax over the sum of the amount of tax reported by the taxpayer and the deficiency assessed in connection with the previous determination. If it is a case where no tax was reported by the taxpayer, the deficiency is the excess of the amount determined to be the correct amount of the tax over the amount of the deficiency disclosed by the previous determination. If the previous determination resulted in a credit or refund to the taxpayer, the deficiency upon the second determination is the excess of the amount determined to be the correct amount of the tax over the amount of tax reported by the taxpayer decreased by the amount of the credit or refund.

(b) *Taxable years beginning after December 31, 1942.* (1) For taxable years beginning after December 31, 1942, the term "deficiency" means the excess of the tax imposed by chapter 1 over the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as a deficiency; but such sum shall first be reduced by the amount of rebates made. If no return is made, or if the return (except a return on Form W-2 (Rev.) pursuant to section 51 (f)) does not show any tax, for the purposes of the definition "the amount shown as the tax by the taxpayer upon his return" shall be considered as zero. Accordingly, in any such case, if no deficiencies have been assessed, or collected without assessment, and no rebates have been made, the deficiency is the amount of the tax imposed by chapter 1. Additional tax shown on an "amended return," so-called, filed after the due date of the return for the taxable year, is a deficiency within the meaning of the Code.

(2) For the purposes of the definition, the tax imposed by chapter 1 and the tax shown on the return shall both be determined without regard to the credit provided in section 35 for tax withheld at the source, and without regard to so much of the credit provided in section 32 for taxes withheld at the source as exceeds 2 percent of the interest on bonds containing a tax-free covenant. Payments on account of estimated tax, like other payments of tax by the taxpayer, shall likewise be disregarded in the determination of a deficiency. For taxable years beginning in 1943, the credit provided in section 466 (e) for Victory tax withheld at the source shall also be disregarded for such purposes.

(3) The computation by the collector, pursuant to section 51 (f), of the tax imposed by chapter 1 shall be considered as having been made by the taxpayer and the tax so computed shall be considered as the tax shown by the taxpayer upon his return.

(4) If so much of the credits claimed on the return for taxes withheld at the source as exceeds 2 percent of the interest on tax-free covenant bonds is greater than the amount of such credits allowable, the unpaid portion of the tax attributable to such difference will be collected not as a deficiency but as an underpayment of the tax shown on the return.

(5) The application of these provisions may be illustrated by the following examples:

Example (1). The amount of tax shown by the taxpayer upon his return for the calendar year 1944 was $1,500. The taxpayer had no amounts previously assessed (or collected without assessment) as a deficiency. He claimed a credit in the amount of $2,000 for tax withheld at source on wages,

and a refund of $500 (not a rebate under section 271) was made to him as an overpayment of tax for the taxable year. It is later determined that the correct tax for the taxable year is $1,750. A deficiency of $250 is determined as follows:

Item		
Tax imposed by chapter 1		$1,750
Tax shown on return	$1,500	
Tax previously assessed (or collected without assessment as a deficiency	None	
Total	1,500	
Amount of rebates made	None	
Balance		1,500
Deficiency		250

Example (2). The taxpayer made a return for the calendar year 1944 showing a tax of $1,250 before any credits for tax withheld at the source. He claimed a credit in the amount of $800 for tax withheld at source on wages under section 1622 and $60 for tax paid at source under section 143 upon interest on bonds containing a tax-free covenant. The taxpayer had no amounts previously assessed (or collected without assessment) as a deficiency. The Commissioner determines that the 2 percent tax paid at the source on tax-free covenant bonds is $40 instead of $60 as claimed by the taxpayer and that the tax imposed by chapter 1 is $1,360 (total tax $1,400 $170 is determined as follows:

Item		
Tax imposed by chapter 1 ($1,400 minus $40)		$1,360
Tax shown on return ($1,250 minus $60)	$1,190	
Tax previously assessed (or collected without assessment) as a deficiency	None	
Total	1,190	
Amount of rebates made	None	
Balance		1,190
Deficiency		170

Example (3). For the calendar year 1945, the taxpayer, a nonresident alien individual not engaged in trade or business within the United States, received gross income from sources within the United States consisting of dividends, and interest on bonds containing a tax-free covenant under which the tax liability assumed by the obligor does not exceed 2 percent of the interest.

The taxpayer made a return showing a tax of $7,860 before any credits for tax withheld at the source. He claimed a credit of $6,000 under section 32 for tax withheld at the source under section 143 of which amount $5,600 was represented as tax withheld, and $400 was represented as the tax at 2 percent paid by the obligor on interest on tax-free covenant bonds described in section 143 (a). The Commissioner determines that the 2 percent tax paid by the obligor on interest on tax-free covenant bonds amounts to $200 instead of $400 as claimed by the taxpayer, and that the tax imposed by chapter 1 is $11,320 (total tax $11,520 less $200 tax paid by obligor on interest on tax-free covenant bonds). The Commissioner also determines that the tax withheld at the source amounts to $7,750 in addition to the $200 paid by the obligor of the bonds. A deficiency in the amount of $3,860 is determined as follows:

Item		
Tax imposed by chapter 1 ($11,520 minus $200)		$11,320
Tax shown on return ($7,860 minus $400)	$7,460	
Tax previously assessed (or collected without assessment) as a deficiency	None	
Total	$7,460	
Amount of rebates made	None	
Balance		7,460
Deficiency		$3,860

(6) As used in section 271, the term "rebate" means so much of an abatement, credit, refund, or other repayment as is made on the ground that the tax imposed by chapter 1 is less than the excess of (i) the amount shown as the tax by the taxpayer upon his return increased by the amount previously assessed (or collected without assessment) as a deficiency over (ii) the amount of rebates previously made. For example, assume that the amount of the tax shown by the taxpayer upon his return for the taxable year is $600 and the amount claimed as a credit under section 35 for tax withheld at the source is $900. If the Commissioner determines that the tax imposed by chapter 1 is $600 and makes a refund of $300 no part of such refund constitutes a "rebate" since the refund is not made on the ground that the tax imposed by chapter 1 is less than the tax shown on the return. If, however, the Commissioner determines that the tax imposed by chapter 1 is $500 and refunds $400, the amount of $100 of such refund would constitute a rebate since it is made on the ground that the tax imposed by chapter 1 ($500) is less than the tax shown on the return ($600). The amount of such rebate ($100) would be taken into account in arriving at the amount of any deficiency subsequently determined.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5447, 10 F. R. 3078]

§ 29.272-1 *Assessment of a deficiency.* If the Commissioner determines that there is a deficiency in respect of the income tax imposed by chapter 1 (see sections 57 and 271), the Commissioner is authorized to notify the taxpayer of

the deficiency by registered mail. If a joint return has been filed by husband and wife the Commissioner may, unless he has been notified by either spouse that a separate residence has been established, send either a joint or separate notice of deficiency. If, however, the Commissioner has been so notified, a separate notice of deficiency, that is, a duplicate original of the joint notice, must be sent by registered mail to each spouse at his or her last known address. The notice to the Commissioner provided for in section 272 (a), relating to separate residences, should be addressed to the Commissioner of Internal Revenue, Washington 25, D. C., for the attention of the Income Tax Unit, Records Division. Within 90 days after notice of the deficiency is mailed (or within 150 days after mailing in the case of such a notice mailed after October 21, 1942, and addressed to a person outside the States of the Union and the District of Columbia), as provided in section 272 (a), a petition may be filed with The Tax Court of the United States for a redetermination of the deficiency. In determining such 90-day or 150-day period, Saturday (on and after September 8, 1945), Sunday, or a legal holiday in the District of Columbia is not to be counted as the ninetieth or one hundred fiftieth day. Except as stated in paragraphs (a), (b), (c), (d), and (e) of this section, no assessment of a deficiency in respect of a tax imposed by chapter 1 shall be made until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, nor, if a petition has been filed with The Tax Court, until the decision of The Tax Court has become final. As to the date on which a decision of The Tax Court becomes final, see section 1140.

(a) If a taxpayer is notified of an additional amount of tax due on account of a mathematical error appearing upon the face of the return, such notice is not to be considered as a notice of deficiency, and the taxpayer has no right to file a petition with The Tax Court upon the basis of such notice, nor is the assessment of such additional tax prohibited by the provisions of section 272 (a).

(b) If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, such deficiency shall be assessed immediately, as provided in section 273. (See § 29.273-1.)

(c) Upon the adjudication of bankruptcy of any taxpayer or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency determined by the Commissioner in respect of the tax shall be assessed immediately, irrespective of the provisions of section 272 (a), if such deficiency has not been assessed in accordance with law prior to the adjudication of bankruptcy or the appointment of a receiver. (See sections 274 and 298 and §§ 29.274-1 and 29.274-2.)

(d) (1) If The Tax Court renders a decision and determines that there is a deficiency, and, if the taxpayer duly files a petition for review of the decision by a circuit court of appeals (or the United States Court of Appeals for the District of Columbia), the filing of the petition will not operate as a stay of the assessment of any portion of the deficiency determined by The Tax Court unless he has filed a bond with The Tax Court as provided in section 1145. If in such a case the necessary bond has not been filed by the taxpayer on or before the time his petition for review is filed, the amount determined by The Tax Court as the deficiency will be assessed immediately after the filing of such petition.

(2) If the Commissioner files a petition for review and (i) if the taxpayer has not filed a petition for review within three months after the decision of The Tax Court is rendered, or (ii) if such petition has been filed by the taxpayer, but the necessary bond referred to in section 1145 has not been filed with The Tax Court on or before the time his petition for review is filed, the amount determined by The Tax Court as the deficiency will be assessed in the case of (iii), immediately after the expiration of the 3-month period, and in the case of (iv), immediately after the filing of the petition for review by the taxpayer.

(e) (1) The taxpayer may at any time by a signed notice in writing filed with the Commissioner waive the restrictions on the assessment of the whole or any part of the deficiency. The notice must in all cases be filed with the Commissioner. The filing of such notice with The Tax Court does not constitute filing with the Commissioner within the meaning of the Internal Revenue Code. After such waiver has been acted upon by the

Commissioner and the assessment has been made in accordance with its terms, the waiver cannot be withdrawn.

(2) If a petition is filed with The Tax Court, the taxpayer should notify the Commissioner that the petition has been filed, in order to prevent an assessment by the Commissioner of the amount determined to be the deficiency. If no petition is filed with The Tax Court within the period prescribed, the Commissioner shall assess the amount determined by him as the deficiency and of which he has notified the taxpayer by registered mail. In such case the Commissioner will not be precluded from determining a further deficiency and notifying the taxpayer thereof by registered mail. Where a petition is filed with The Tax Court, the entire amount redetermined as the deficiency by the decision of The Tax Court which has become final shall be assessed by the Commissioner. If the Commissioner mails to the taxpayer notice of a deficiency, and the taxpayer files a petition with The Tax Court within the prescribed period, the Commissioner is barred from determining any additional deficiency for the same taxable year except in the case of fraud and except as provided in section 272 (e) relating to the assertion of greater deficiencies before The Tax Court or in section 273 relating to jeopardy assessments.

[Regs. 111, 8 F. R. 15002 as amended by T. D. 5503, 11 F. R. 3081]

§ 29.272-2 *Collection of a deficiency.* Where a deficiency as redetermined by a decision of The Tax Court which has become final is assessed, or where the taxpayer has not filed a petition and the deficiency as determined by the Commissioner has been assessed, the unpaid portion of the amount so assessed shall be paid upon notice and demand from the collector. As to cases coming within the provisions of paragraphs (b), (c), and (d) of § 29.272-1, see sections 273 (i) and 298 and section 1145. As to interest on deficiencies, see section 292.

[Regs. 111, 8 F. R. 15002 as amended by T. D. 5447, 10 F. R. 3079]

§ 29.272-3 *Extension of time for payment of a deficiency.* (a) If it is shown to the satisfaction of the Commissioner that the payment of a deficiency upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner may grant an extension of time for the payment of the deficiency or any part thereof for a period not in excess of 18 months, and in exceptional cases for a further period not in excess of 12 months. The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the deficiency at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. The Internal Revenue Code provides that no extension will be granted where the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade tax.

(b) An application for an extension of time for the payment of a deficiency should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the month in which falls the date prescribed for the payment of the deficiency are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a deficiency unless request therefor is made to the collector on or before the date prescribed for payment thereof, as shown by the notice and demand from the collector, or on or before the date or dates prescribed for payment in any prior extension granted.

(c) As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1127B in an amount not

exceeding double the amount of the deficiency or to furnish other security satisfactory to the Commissioner for the payment of the liability on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the deficiency, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States as provided in section 1126 of the Revenue Act of 1926. The amount of the deficiency and additions thereto shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand from the collector. Payment of the deficiency and additions thereto before the expiration of the extension will not relieve the taxpayer from paying the entire amount of interest provided for in the extension. (See section 296.)

§ 29.273-1 *Jeopardy assessments.* (a) If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he is required to assess such deficiency immediately, together with the interest and other additional amounts provided by law. If a deficiency is assessed on account of jeopardy after the decision of The Tax Court of the United States is rendered, the jeopardy assessment may be made only with respect to the deficiency determined by The Tax Court. The Commissioner is prohibited from making a jeopardy assessment after a decision of The Tax Court has become final (see section 1140), or after the taxpayer has filed a petition for review of the decision of The Tax Court.

(b) If notice of a deficiency was mailed to the taxpayer (see section 272 (a)) before it was discovered that delay would jeopardize the assessment or collection of the tax, a jeopardy assessment may be made in an amount greater or less than that included in the deficiency notice. On the other hand if the assessment on account of jeopardy was made without mailing the notice required by section 272 (a), the Commissioner must within 60 days after the making of the assessment send the taxpayer notice of the deficiency by registered mail. The taxpayer may file a petition with The Tax Court for a redetermination of the amount of the deficiency within 90 days after such notice is mailed (or within 150 days after mailing in the case of such a notice mailed after October 21, 1942, and addressed to a person outside the States of the Union and the District of Columbia) not counting Saturday (on and after September 8, 1945), Sunday, or a legal holiday in the District of Columbia as the ninetieth or one hundred fiftieth day. The Commissioner may, at any time before the decision of The Tax Court is rendered, abate such assessment, or any unpaid portion thereof, to the extent that he believes the assessment to be excessive in amount. If the petition of the taxpayer is filed with The Tax Court, either before or after the making of the jeopardy assessment, the Commissioner is required to notify The Tax Court of such assessment or abatement, and The Tax Court has jurisdiction to redetermine the amount of the deficiency together with all other amounts assessed at the same time in connection therewith. (See section 273 (c).)

(c) After a jeopardy assessment has been made, the list showing such assessment will be immediately transmitted to the collector. Upon receipt of the list containing the assessment, the collector is required to send notice and demand to the taxpayer for the amount of the jeopardy assessment. Regardless of whether the taxpayer has filed a petition with The Tax Court, he is required to make payment of the amount of such assessment (to the extent that it has not been abated) within 10 days after the sending of notice and demand by the collector, unless before the expiration of such 10-day period he files with the collector a bond on Form 1429 of the character hereinafter prescribed. The bond must be in such amount, not exceeding double the amount for which the stay is desired, as the collector deems necessary and must be executed by sureties satisfactory to the collector. It must be conditioned upon the payment of so much of the amount included therein as is not abated by a decision of The Tax Court which has become final, together with the in-

terest on such amount provided for in section 297. If the bond is given before the taxpayer has filed his petition with The Tax Court, it must contain a further condition that if a petition is not filed before the expiration of the 90-day or 150-day period provided for the filing of such petition, the amount stayed by the bond will be paid upon notice and demand at any time after the expiration of such period, together with interest thereon at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of the notice and demand made after the expiration of the 90-day or 150-day period. If a petition is not filed with The Tax Court within the 90-day or 150-day period, the collector will be so advised, and, if collection of the deficiency has been stayed by the filing of a bond within 10 days after the date of jeopardy notice and demand, he should then give notice and make demand for payment of the amount assessed plus interest. Any bond filed after the expiration of 10 days from the date of the jeopardy notice and demand is not such a bond as is contemplated by section 273 (f), and, while the collector may in his discretion accept the bond and stay collection of the deficiency, the taxpayer will not be relieved from payment of interest on the amount of the deficiency at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of payment.

(d) Upon the filing of a bond of the character described within 10 days after the date of notice and demand for payment of the amount assessed, the collection of so much thereof as is covered by the bond will be stayed. The taxpayer may at any time waive the stay of collection of the whole or any part of the amount covered by the bond. If as a result of such waiver any part of the amount covered by the bond is paid, or if any portion of the jeopardy assessment is abated by the Commissioner before the decision of The Tax Court is rendered, then the bond shall at the request of the taxpayer be proportionately reduced. If The Tax Court determines that the amount assessed is greater than the correct amount of the tax, the bond will also be proportionately reduced at the request of the taxpayer after The Tax Court renders its decision.

(e) After The Tax Court has rendered its decision and such decision has become final, the collector will be notified of the action taken. The collector will then send notice and demand for the unpaid portion of the amount determined by The Tax Court, the collection of which has been stayed by the bond. The collector is required to include in the notice and demand for the unpaid portion, interest at the rate of 6 percent per annum from the date of the jeopardy notice and demand to the date of the notice and demand referred to in this paragraph. If the amount of the jeopardy assessment is less than the amount determined by The Tax Court, the difference, together with interest as provided in section 292, will be assessed, and collected as part of the tax upon notice and demand from the collector. If the amount included in the notice and demand made after the decision of The Tax Court is not paid within 10 days after such notice and demand, there shall be collected as part of the tax, interest as provided in section 294 (b). If the amount of the jeopardy assessment is in excess of the amount determined by The Tax Court, the unpaid portion of such excess will be abated. If any part of the excess amount has been paid, it will be credited or refunded to the taxpayer as provided in section 322.

(f) As to bankruptcy, proceedings for the relief of debtors and receivership cases, see sections 274 and 298 and §§ 29.274-1 and 29.274-2.

[Regs. 111, 8 F. R. 15002 as amended by T. D. 5503, 11 F. R. 3081]

§ 29.274-1 *Bankruptcy and receivership proceedings.* (a) During a bankruptcy proceeding, or an equity receivership proceeding in either a Federal or a State court, the assets of the taxpayer are in general under the control of the court in which such proceeding is pending, and the collection of taxes cannot be made by distraining upon such assets. However, any assets which under applicable provisions of law are not under the control of the court may be subject to distraint.

(b) As used in this subpart the term "bankruptcy proceeding" includes proceedings under Chapters I to VII of the Bankruptcy Act, as amended, or under section 74, 75, 77, or 77B, or Chapters X to XIII, or Chapter XV, of such act, as amended; and the term "adjudication of bankruptcy" includes, in addition to an adjudication in a proceeding under Chapters I to VII, the approval of a petition as properly filed under section 77

or 77B or Chapter X by a court of competent jurisdiction or the filing of a petition under section 74 or 75 or Chapters XI to XIII or Chapter XV with a court of competent jurisdiction.

(c) A trustee in bankruptcy (including a trustee, receiver, debtor in possession, or other person designated as in control of the assets of a debtor in any bankruptcy proceeding by order of the court in which such proceeding is pending) or a receiver in any receivership proceeding is required to give notice in writing to the Commissioner of Internal Revenue in Washington 25, D. C., of the adjudication of bankruptcy or the appointment of a receiver. (See section 274 (a) and § 29.275-1.)

(d) Collectors should, promptly after notice of outstanding liability against a taxpayer in any bankruptcy or receivership proceeding, and in any event within the time limited by the appropriate provisions of the Bankruptcy Act, as amended, and the orders of the court in which such proceeding is pending, file claim covering such liability in the court in which such proceeding is pending. Such claim should be filed whether the unpaid taxes involved have been assessed or not, except in cases where the departmental instructions direct otherwise; for example, where the payment of the taxes is secured by a sufficient bond. Such claims should cover the amount represented by the assessment, plus interest at the rate of 6 percent per annum for the period from the date of filing claim by the collector to the date of termination of the bankruptcy or receivership proceeding or to the date of payment if payment is made in full prior to such termination. At the same time claim is filed with the bankruptcy or receivership court, the collector will send notice and demand for payment to the taxpayer together with a copy of such claim.

(e) Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended, and section 64 of the Bankruptcy Act, as amended, taxes are entitled to the priority over other claims therein stated and the trustee, receiver, debtor in possession, or other person designated as in control of the assets of the debtor by the court in which bankruptcy or receivership proceeding is pending, may be held personally liable for failure on his part to protect the priority of the Government respecting taxes of which he has notice. Bankruptcy courts have jurisdiction under the Bankruptcy Act, as amended, to determine all disputes regarding the amount and validity of taxes of a bankrupt or of a debtor in a proceeding under the Bankruptcy Act, as amended. A bankruptcy or receivership proceeding does not discharge any portion of a claim of the United States for taxes except in the case of a proceeding under Chapter X of the Bankruptcy Act, as amended, and except to the extent which may be provided in a plan or arrangement duly effectuated in a bankruptcy proceeding; and any portion of a claim of the United States for taxes which has been allowed by the court in which the bankruptcy or receivership proceeding is pending and which remains unsatisfied after the termination of the bankruptcy or receivership proceeding shall be collected with interest as provided in section 298.

§ 29.274-2 *Immediate assessments in bankruptcy and reccivership cases.* (a) If the Commissioner has determined that a deficiency is due in respect of income tax and the taxpayer has filed a petition with The Tax Court of the United States prior to the adjudication of bankruptcy or the appointment of a receiver, the trustee, receiver, debtor in possession, or other person designated as in control of the assets of the debtor by the court in which the bankruptcy or receivership proceeding is pending, may prosecute the taxpayer's appeal before The Tax Court as to that particular determination. No petition shall be filed with The Tax Court for a redetermination of the deficiency after the adjudication of bankruptcy or the appointment of a receiver.

(b) Claim for the amount of a deficiency, even though pending before The Tax Court for consideration, may be filed with the court in which the bankruptcy or receivership proceeding is pending without awaiting final decision of The Tax Court. In case of final decision of The Tax Court before the termination of the bankruptcy, debtor, or receivership proceeding, a copy of The Tax Court's decision may be filed by the Commissioner with the court in which such proceeding is pending.

(c) While the Commissioner is required by section 274 to make immediate assessment of any deficiency, such assessment is not made as a jeopardy assessment within the meaning of section 273, and consequently the provisions of

that section do not apply to any assessment made under section 274. Therefore, the notice of the deficiency provided for in section 273 (b) will not be mailed. Although such notice will not be issued, nevertheless a letter will be sent to the taxpayer, or to the trustee, receiver, debtor in possession, or other person designated by the court in which the bankruptcy or receivership proceeding is pending as in control of the assets of the debtor, notifying him in detail how the deficiency was computed, that he may furnish evidence showing wherein the deficiency is incorrect, and that upon request he will be granted a hearing with respect to such deficiency. If after such evidence is submitted and hearing held any adjustment appears necessary in the deficiency, appropriate action will be taken. A copy of the notification letter will be attached to the assessment list as the collector's authority for filing claim in any bankruptcy or receivership proceeding.

(d) If any portion of the claim allowed by the court in a bankruptcy or receivership proceeding remains unpaid after the termination of such proceeding, the collector will send notice and demand for payment thereof to the taxpayer. Such unpaid portion with interest as provided in section 298 may be collected from the taxpayer by distraint or proceeding in court within six years after the termination of the bankruptcy or receivership proceeding. Extensions of time for the payment of such unpaid amount may be granted in the same manner and subject to the same provisions and limitations as provided in sections 272 (j) and 297. (See § 29.272-3.)

This section deals only with immediate assessments provided for in section 274 and the procedure in connection with such assessments.

§ 29.275-1 *Period of limitation upon assessment of tax.* The amount of income tax imposed by the Internal Revenue Code must be assessed within three years after the return was filed. For the purposes of subsections (a), (b), (c), (d), and (e) of section 275, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day. Exceptions to the period of limitation stated in this paragraph (other than those provided for elsewhere in the Code) are as follows:

(a) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation contemplating dissolution, the tax shall be assessed within 18 months after written request therefor by the fiduciary or legal representative of the estate of the decedent or by the corporation, but not after the expiration of three years after the return was filed. The effect of this provision is to limit the period in which the Commissioner may assess the tax in such cases to a period of 18 months from the date the request is filed, even though more than 18 months still remain of the regular 3-year period in which the assessment may under ordinary circumstances be made. The request, in order to be effective, must be made after the return is filed and must be in such language as to make it clear to the Commissioner that it is desired to take advantage of the provisions of section 275 (b). In the case of a corporation the 18-month period of limitation shall not apply unless:

(1) The written request notifies the Commissioner that the corporation contemplates dissolution at or before the expiration of such period,

(2) The dissolution is in good faith begun before the expiration of such period, and

(3) The dissolution so begun is completed either before or after the expiration of such 18-month period.

Such a request does not have the effect of extending the regular period of limitation even though the request is made less than 18 months before the expiration of the regular period of limitation.

(b) If a corporation makes no income tax return under the Internal Revenue Code, but each of the shareholders includes in his personal return his distributive share of the net income of the corporation, the tax of the corporation shall be assessed within four years after the last date on which any such shareholder's return was filed.

(c) In the case of a false or fraudulent return with intent to evade tax, the tax may be assessed at any time after such false or fraudulent return is filed.

(d) If there is omitted from the gross income stated in the return an amount properly includible therein which is in excess of 25 percent of the gross income so stated, the tax may be assessed at any time within five years after the return was filed.

(e) In the event the taxpayer fails to file a return, the amount of tax due may be assessed at any time after the date prescribed for filing the return. (But see paragraph (b) of this section.)

(f) If the taxpayer omits from gross income an amount properly includible therein under section 337 (b) as his distributive share of the undistributed Supplement P net income of a foreign personal holding company (see sections 331 to 340, inclusive) or an amount properly includible therein under section 394 (b) as his distributive share of the Supplement S net income of a personal service corporation (see sections 391 to 396, inclusive), the tax may be assessed at any time within seven years after the return was filed.

(g) If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an amount distributed in liquidation of a corporation, other than a foreign personal holding company, the tax may be assessed at any time within four years after the return was filed.

(h) If before the expiration of the time prescribed in section 275 for the assessment of the tax the Commissioner and the taxpayer have consented in writing to the assessment of the tax after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(i) If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a), then the running of the statute of limitations on assessment of any deficiency shall be suspended for the period during which the Commissioner is prohibited from making the assessment (and in any event, if a proceeding in respect of the deficiency is placed on the docket of The Tax Court of the United States, until the decision of The Tax Court beeomes final), and for 60 days thereafter. If the Commissioner mails to a taxpayer a notice of deficiency within the statutory period of limitation and the taxpayer does not appeal therefrom to The Tax Court, the notice of deficiency so given does not suspend the running of the period of limitation on assessment for the purpose of any additional deficiency shown to be due in a subsequent deficiency notice.

(j) In a bankruptcy or receivership proceeding the running of the statute of limitations on the making of assessments is suspended from the date of adjudication in bankruptcy or the date of the appointment of a receiver, as the case may be, to a date 30 days after the date upon which the notice provided for in section 274 (a) is received by the Commissioner in Washington, D. C., but in no case shall the suspension be for a period in excess of two years. See section 274 (a) and §§ 29.274-1 and 29.274-2.

With respect to the period of limitation for assessing the amount of the liability of a transferee of property, or for assessing the amount of the liability of a fiduciary under section 3467 of the Revised Statutes, as amended, see section 311.

(k) A special period of limitation is provided in section 276 (d) within which a deficiency in any tax (including a deficiency which may be assessed pursuant to the provisions of section 3780 (b) or (c), relating to tentative carry-back adjustments) which is attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back may be assessed. The period within which such a deficiency may be assessed depends, in general, on the period within which a deficiency may be assessed with respect to the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back. The period within which such a deficiency may be assessed depends further on whether an excess profits tax return was required to be filed in the case of the given taxpayer for the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back. It is immaterial whether an excess profits tax return was required to be filed for the taxable year of the deficiency. The determinative factor is whether an excess profits tax return was required to be filed for the taxable year of the loss or unused credit which resulted in the carry-back.

(l) If an excess profits tax return was required to be filed for the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back, a deficiency in any tax attributable to the application to the taxpayer of such carry-back may be assessed at any time prior to the expiration of the period within which (under the provisions of section 275 or 276 (a) or (b), and

sections 603 and 729 (a) respectively making such sections 275 and 276 (a) and (b) applicable to subchapters B and E of chapter 2) a deficiency may be assessed with respect to the same or any other tax imposed by chapter 1 or subchapter B or E of chapter 2 for the taxable year of such loss or unused credit. In such case, a deficiency attributable to the application to the taxpayer of a carry-back thus may be assessed at any time prior to the expiration of whichever of the following three periods, each period being determined under the applicable provisions of sections 275, 276 (a) and (b), 603, and 729 (a), expires the latest:

(1) The period within which a deficiency may be assessed with respect to the tax imposed by chapter 1 for the taxable year of the loss or unused credit which resulted in the carry-back;

(2) The period within which a deficiency may be assessed with respect to the declared value excess profits tax, imposed by subchapter B of chapter 2, for the taxable year of the loss or unused credit which resulted in the carry-back;

(3) The period within which a deficiency may be assessed with respect to the excess profits tax, imposed by subchapter E of chapter 2, for the taxable year of the loss or unused credit which resulted in the carry-back.

(m) If a corporation is not subject to the declared value excess profits tax for the taxable year of the loss or unused credit which resulted in the carry-back, either because its net income, determined as provided in section 602, for such taxable year is not in excess of 10 percent of its declared value or because such taxable year ended after June 30, 1946, the period within which a deficiency may be assessed with respect to the declared value excess profits tax for the taxable year of the loss or unused credit shall be disregarded in determining the period within which a deficiency attributable to the application to the taxpayer of a carry-back, resulting from such loss or unused credit, may be assessed.

(n) If no excess profits tax return was required to be filed for the taxable year of the net operating loss or unused excess profits credit which resulted in the carry-back, a deficiency in any tax attributable to the application to the taxpayer of such carry-back may be assessed at any time prior to the expiration of the period within which (under the provisions of section 275 or 276 (a) or (b), and sections 508 and 603 respectively making such sections 275 and 276 (a) and (b) applicable to subchapters A and B of chapter 2) a deficiency may be assessed with respect to the same or any other tax imposed by chapter 1 or subchapter A or B of chapter 2 for the taxable year of such loss or unused credit. It will be considered that no excess profits tax return was required to be filed for the taxable year of the loss or unused credit if (1) the taxpayer was exempt from the excess profits tax for such taxable year under the provisions of section 727; (2) the taxpayer, even though subject to the excess profits tax, was not required to file an excess profits tax return for such taxable year under the provisions of section 729; or (3) such taxable year began after December 31, 1945. In such case, a deficiency attributable to the application to the taxpayer of a carry-back thus may be assessed at any time prior to the expiration of whichever of the following three periods, each period being determined under the applicable provisions of sections 275, 276 (a) and (b), 508, and 603, expires the latest:

(i) The period within which a deficiency may be assessed with respect to the tax imposed by chapter 1 for the taxable year of the loss or unused credit which resulted in the carry-back;

(ii) The period within which a deficiency may be assessed with respect to the surtax on personal holding companies, imposed by subchapter A of chapter 2, for the taxable year of the loss or unused credit which resulted in the carry-back;

(iii) The period within which a deficiency may be assessed with respect to the declared value excess profits tax, imposed by subchapter B of chapter 2, for the taxable year of the loss or unused credit which resulted in the carry-back.

(o) If a corporation is not a personal holding company, as defined in section 501, for the taxable year of the loss or unused credit which resulted in the carry-back, the period within which a deficiency may be assessed with respect to the surtax on personal holding companies for the taxable year of the loss or unused credit shall be disregarded in determining the period within which a deficiency attributable to the application to the taxpayer of a carry-back, resulting from such loss or unused credit,

may be assessed. Similarly, if a corporation is not subject to the declared value excess profits tax for the taxable year of the loss or unused credit which resulted in the carry-back, either because its net income, determined as provided in section 602, for such taxable year is not in excess of 10 percent of its declared value or because such taxable year ended after June 30, 1946, the period within which a deficiency may be assessed with respect to the declared value excess profits tax for the taxable year of the loss or unused credit shall be disregarded in determining the period within which a deficiency attributable to the application to the taxpayer of a carry-back, resulting from such loss or unused credit, may be assessed.

(p) It is immaterial whether an excess profits tax return in fact was filed for the taxable year of the loss or unused credit which resulted in the carry-back, whether the deficiency is attributable to the application to the taxpayer of a net operating loss carry-back or an unused excess profits credit carry-back whether the deficiency is in respect of the excess profits tax or some other tax, or whether the deficiency is in respect of the same tax as that of the carry-back or in respect of some other tax. The determinative factor is whether an excess profits tax return was required to be filed for the taxable year of the loss or unused credit which resulted in the carry-back. It is likewise immaterial whether the tax, in respect of which the deficiency resulting from the application to the taxpayer of the carry-back is to be assessed, is the same kind of tax with respect to which a deficiency might be assessed for the taxable year of the loss or unused credit which resulted in the carry-back. Thus, if a deficiency for the calendar year 1943 with respect to the tax imposed by chapter 1 is attributable to the application to the taxpayer of a net operating loss carry-back from 1945, and if the taxpayer was required to file an excess profits tax return for 1945 and if the periods within which deficiencies with respect to the taxes imposed by chapter 1, subchapter B of chapter 2, and subchapter E of chapter 2 for 1945 expire respectively on March 15, 1949, March 15, 1949, and September 15, 1949, the period within which such deficiency, attributable to the application to the taxpayer of the net operating loss carry-back from 1945, may be assessed with respect to the tax imposed by chapter 1 for 1943 will expire on September 15, 1949.

(q) A deficiency attributable to the application to the taxpayer of a carry-back may result from an adjustment to the net operating loss or the unused excess profits credit, to the resulting carry-back, or to the net operating loss deduction or the unused excess profits credit adjustment. A deficiency may be attributable to the application to the taxpayer of a carry-back even though the net operating loss or the unused excess profits credit or the resulting carry-back, as claimed by the taxpayer, is identical in amount with the actual loss or unused credit or the resulting carry-back. For example, if in computing the net operating loss deduction the taxpayer fails to make the adjustment required by section 122 (c), the resulting deficiency will be considered to be attributable to the application to the taxpayer of any net operating loss carry-back which entered into the computation of such net operating loss deduction. A deficiency in excess profits tax attributable to the application to the taxpayer of an unused excess profits credit carry-back which itself is produced, or which is increased in amount, by a net operating loss carry-back is to be considered as likewise attributable to the application to the taxpayer of such net operating loss carry-back to the extent that such unused excess profits credit carry-back is so produced or increased; such deficiency may be assessed at any time prior to the expiration of whichever of the following two periods expires later; the period prescribed in section 276 (d) within which a deficiency attributable to the application to the taxpayer of such unused excess profits credit carry-back may be assessed, or the period prescribed in section 276 (d) within which a deficiency attributable to the application to the taxpayer of such net operating loss carry-back may be assessed.

If the period within which a deficiency may be assessed under any other applicable provision of law, both in the case where an excess profits tax return was required to be filed for the taxable year of the loss or unused credit which resulted in the carry-back and in the case where no excess profits tax return was required to be filed for such taxable year, is longer than the period provided in section 276 (d), a deficiency attributable to the application to the taxpayer of such carry-back may be assessed at any time

prior to the expiration of such longer period.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5516, 11 F. R. 5858]

§ 29.275-2 *Period of limitation upon collection of tax.* In the case of the income taxes imposed by the Internal Revenue Code, a proceeding in court without assessment for the collection of such tax must be begun within three years after the return was filed.

The exceptions to the period of limitation upon collection of the tax without assessment stated in the preceding paragraph are as follows:

(a) In the case of income received during the lifetime of a decedent or by his estate during the period of administration, or by a corporation, a proceeding in court for the collection of the tax without assessment must be begun within 18 months after a written request therefor by the executor, administrator, or other fiduciary representing the estate of the decedent, or by the corporation, but not after the expiration of three years after the return was filed. Such a request does not have the effect of extending the regular period of limitation within which a proceeding in court without assessment may be begun, even though the request is made less than 18 months before the expiration of the regular period of limitation, nor is it of any effect if made before the return is filed. In the case of a corporation the conditions stated in paragraph (a) (1), (2), and (3) of § 29.275-1 also must be met.

(b) A proceeding in court for the collection of the tax without assessment may be begun at any time:

(1) In case the taxpayer files a false or fraudulent return with intent to evade tax; or

(2) In case the taxpayer fails to file a return.

(c) If there is omitted from the gross income stated in the return an amount properly includible therein which is in excess of 25 percent of the gross income so stated, a proceeding in court for the collection of the tax may be begun without assessment at any time within five years after the return was filed.

(d) If the taxpayer omits from gross income an amount properly includible therein under section 337 (b) as his distributive share of the undistributed Supplement P net income of a foreign personal holding company (see sections 331 to 340, inclusive), or an amount properly includible therein under section 394 (b) as his distributive share of the Supplement S net income of a personal service corporation (see sections 391 to 396, inclusive), a proceeding in court for the collection of the tax may be begun without assessment at any time within seven years after the return was filed.

(e) If the taxpayer omits from gross income an amount properly includible therein under section 115 (c) as an amount distributed in liquidation of a corporation, other than a foreign personal holding company, a proceeding in court for the collection of the tax may be begun without assessment at any time within four years after the return was filed.

In any case in which the tax has been assessed within the statutory period of limitation properly applicable thereto, a proceeding in court or distraint for the collection of such tax may be begun within six years after the assessment thereof, or prior to the expiration of any period for collection agreed upon in writing by the Commissioner and the taxpayer before the expiration of such 6-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. In determining the running of the statute of limitations in respect of distraint, the distraint shall be held to have been begun, in the case of personal property, on the date on which the levy upon such property is made, or, in the case of real property, on the date on which notice of the time and place of sale is given to the person whose estate it is proposed to sell.

If a notice of a deficiency has been mailed to the taxpayer under the provisions of section 272 (a) (see § 29.272-1), then the running of the statute of limitations on the beginning of distraint after assessment or on the beginning of a proceeding in court after assessment or without assessment, in respect of any deficiency, shall be suspended for the period during which the Commissioner is prohibited from beginning such distraint or proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of The Tax Court of the United States, until the decision of The Tax Court becomes final), and for 60 days thereafter.

With respect to the period of limitation upon the collection of the tax on unpaid claims in bankruptcy or receivership proceedings, see section 274 (b) and § 29.274-2.

INTEREST AND ADDITIONS TO THE TAX

§ 29.291-1 *Addition to the tax in case of failure to file return.* (a) In case of failure to make and file a return required by chapter 1 within the prescribed time, a certain percent of the amount of the tax is added to the tax unless failure to file the return within the prescribed time is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect. The amount to be added to the tax is 5 percent if the failure is for not more than 30 days, with an additional 5 percent for each additional 30 days or fraction thereof during which failure continues, not to exceed 25 percent in the aggregate.

(b) A taxpayer who wishes to avoid the addition to the tax for delinquency must make an affirmative showing of all facts alleged as a reasonable cause for failure to file the return on time in the form of an affidavit which should be filed with the collector, who, unless otherwise directed by the Commissioner, will forward the affidavit to the Commissioner, and, if the Commissioner determines that the delinquency was due to a reasonable cause, and not to willful neglect, the addition to the tax will not be assessed. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

(c) If the addition to the tax for delinquency in filing the return has been added, the amount so added shall be collected in the same manner as the tax.

(d) For addition to the tax in case of a deficiency due to fraud with intent to evade tax, see section 293. As to the making of returns for taxpayers by collectors or the Commissioner in the case of delinquency in filing a return, or in the case of a false or fraudulent return, see section 3612.

PENALTIES IN CONNECTION WITH ESTIMATED TAX

§ 29.294-1 *Additions to the tax*—(a) *General.* Section 294 (d) provides for certain additions to the tax in the case of:

(1) Failure to file timely a declaration of estimated tax;

(2) Failure to pay within the time prescribed any installment of declared estimated tax; and

(3) Substantial underestimate of the estimated tax.

These additions to the tax are in addition to any applicable criminal penalties.

(b) *Additions for specific failures on the part of the taxpayer with respect to the estimated tax*—(1) *Failure to file declaration.* Section 294 (d) (1) (A) provides for an addition to the tax in the case of a failure to make and file a declaration of estimated tax within the time prescribed unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not due to willful neglect. Such addition to the tax shall be in an amount equal to 5 percent of the unpaid amount of each installment and in addition 1 percent of the unpaid amount of the installment for each month (except the first) or fraction thereof during which such amount remains unpaid. Such addition to the tax with respect to any installment due but unpaid shall not exceed 10 percent of the unpaid portion of such installment. For the purposes of section 294 (d) (1) (A) the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits for tax withheld at source.

The application of section 294 (d) (1) (A) for taxable years beginning in 1943 in the case of taxpayers not entitled to elect under section 60 (a), relating to farmers, may be illustrated by the following examples:

Example (1). An individual filed a declaration on November 15, 1943, for the calendar year 1943, disclosing an estimated tax of $2,400, and paid installments of $700 each on November 15 and December 15, 1943. He had made payments of $500 each on March 15 and June 15, 1943, on account of tax for 1942 for which he claimed credit as payments on account of estimated tax. On March 15, 1944, he filed a return on Form 1040 showing a correct tax, without regard to section 6 of the Current Tax Payment Act of 1943, of $4,000 and paid the balance of the tax due, $1,600. Examination of his return disclosed that his entire income consisted of dividends and interest The failure to file a timely declaration was not due to reasonable cause. Hence the individual is subject to the penalty imposed by section 294 (d) (1) (A). Under the facts assumed, installments of tax in the amount of $1,500 each were due and payable on September 15 and December 15, 1943, that

is, one-half of $3,000, the balance of correct tax remaining after taking into account the two payments of $500 each made on March 15 and June 15, 1943, respectively. The entire amount of the September installment of $1,500 remained unpaid for two months; $800 of the same installment remained unpaid for four months; and $800 of the December installment remained unpaid for three months. The addition to the tax under section 294 (d) (1) (A), subject to the limitation of 10 percent of the unpaid amount of each installment, is computed as follows:

Unpaid amount	Percentage	Penalty before limitation	10% limitation	Addition to tax
Sept.......... $1,500	5% plus 1%...	$90		
800	4 times 1%...	32		
		122	$150	$122
Dec.......... 800	5% plus 2%..	56	80	56
Total addition to tax under section 294 (d) (1) (A).	....	......	......	178

Example (2). A and B, husband and wife, are each required to file a declaration of estimated tax on or before September 15, 1943, for the calendar year 1943, but without reasonable cause fail to do so until October 15, 1943. Upon the latter date A and B file separate declarations. On the same date and also on December 15 of such year A pays $200 and B pays $50 as installments of estimated tax. A claims $100 as payment on account of estimated tax for two installments of $50 each paid on March 15 and June 15, 1943, respectively, as installments of tax for 1942. B likewise claimed $50 as payment on account of estimated tax for two installments of $25 each paid on March 15 and June 15, 1943, respectively, as installments of tax for 1942. On March 15, 1944, A and B file a joint return for the calendar year 1943, showing a correct tax without regard to section 6 of the Current Tax Payment Act of 1943 in the amount of $750 after credit for tax withheld at source. Under section 294 (d) (1) (A) the addition to such tax for failure to file declarations until October 15, 1943, would be $21, that is, the sum of (1) 5 percent of $300, the amount of the first installment of the correct tax which was unpaid for one month, (2) 5 times 1 percent of $50, the amount of the installment of the correct tax which was unpaid for six months, (3) 5 percent of $50, the amount of the second installment of the correct tax which was unpaid for one month, and (4) twice 1 percent of $50 the amount of the second installment of the correct tax which was unpaid for three months.

Example (3). On September 30, 1943, C and D file a joint declaration for the calendar year 1943. The delay was not due to reasonable cause. They file separate income tax returns for that year. C's correct tax for 1943, without regard to section 6 of the Current Tax Payment Act of 1943, amounts to $550, and D's correct tax for that year, similarly determined, amounts to $250. C and D declared $900 as their estimated tax. They claimed $100 as payments on account of estimated tax for two installments of $50 each paid on March 15 and June 15, 1943, respectively, as installments of tax for 1942 on the basis of a joint return filed for that year. They paid two installments of estimated tax of $400 each on September 30 and December 15, 1943. C and D are jointly liable for the addition to the tax for failure to file a timely declaration in the amount of $17.50, computed as follows:

C's correct tax........................	$550
D's correct tax........................	250
Total	$800
Less: Payments made on account of tax for 1942........................	100
Balance	$700
Balance divided by 2 (number of installments due)........	$350
Addition to the tax (5% of $350)......	$17.50

(2) *Failure to pay installment of declared estimated tax*. Section 294 (d) (1) (B) provides for an addition to the tax in the case of the failure to pay an installment of the declared estimated tax within the time prescribed unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not due to willful neglect. Such addition to the tax is applicable to delinquency in payment only (i) where a timely declaration of estimated tax has been made and filed or (ii) where the Commissioner has found that the failure to make and file a timely declaration was due to reasonable cause and not to willful neglect. Such addition to the tax shall be in an amount equal to 5 percent of the unpaid amount of each installment of declared estimated tax and in addition 1 percent of such unpaid amount for each month (except the first) or fraction thereof during which such amount remains unpaid. The addition to the tax is limited with respect to any installment due but unpaid to 10 percent of the unpaid portion of such installment. Such addition to the tax is not applicable in cases to which the addition to the tax under section 294 (d) (1) (A) applies.

The application of section 294 (d) (1) (B) for taxable years beginning in 1943 in the case of taxpayers not entitled to elect under section 60 (a), relating to farmers, may be illustrated by the following examples:

Example (1). For the calendar year 1943 E and F, husband and wife, file timely declarations. E's separate declaration discloses a balance of estimated tax in the amount of $200. Instead of making timely payment of one installment of $100, he pays such amount ten days after the due date. The delay in payment was not due to reasonable cause. F is similarly delinquent with respect to one installment of $50 of her balance of estimated tax of $100. On the joint return of E and F for 1943 the addition to the tax with respect to the delinquent installments of estimated tax will be $7.50, which is the sum of 5 percent of $100 and 5 percent of $50.

Example (2). The timely joint declaration of G and H for the calendar year 1943 discloses a balance of estimated tax in the amount of $250. G and H are delinquent without reasonable cause for a period of less than one month in the payment of one installment of $125. They file separate income tax returns for 1943. They are jointly and severally liable for the payment of the addition to the tax for delay in paying an installment of estimated tax. Such addition amounts to $6.25, that is, 5 percent of $125.

(3) *Substantial understatement of estimated tax.* Section 294 (d) (2) provides for an addition to the tax in the case of a taxpayer who makes a substantial underestimate of tax on his declaration. Such addition to the tax shall not apply to the taxable year in which falls the death of the taxpayer.

For taxable years beginning after December 31, 1942, except as hereinafter provided:

(i) In the case of individuals, other than those exercising the election under section 60 (a), relating to farmers, an addition to the tax under section 294 (d) (2) is applicable in the event that the amount of the estimated tax (increased by the amount of the credit for taxes withheld at source on wages and the credit under section 32) is less than 80 percent of the tax imposed by Chapter 1 for the taxable year (determined without regard to such credits). In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this provision is zero.

(ii) In the case of individuals exercising the election under section 60 (a), relating to farmers, the addition to the tax is applicable if the amount of the estimated tax increased by the amount of the credit for taxes withheld at source on wages and the credit under section 32 is less than 66⅔ percent of the amount of the tax (determined without regard to such credits).

(iii) The addition to the tax in any case in which there has been such underestimate as comes within the scope of section 294 (d) (2) is an amount equal to:

(*a*) The excess of 80 percent of the tax (or 66⅔ percent in the case of farmers exercising an option under section 60 (a)) determined without regard to the credit for taxes withheld at source on wages and the credit under section 32 over the amount of the estimated tax increased by such credits; or

(*b*) 6 percent of the excess of the tax determined without regard to the credit for taxes withheld at source on wages and the credit under section 32 over the amount of the estimated tax increased by such credits,

whichever (*a*) or (*b*) is the lesser.

In the case of a taxpayer filing a declaration of estimated tax for a taxable year beginning in 1944, the term "tax" as it appears in the expressions "80 percent of the tax" in subdivisions (i) and (iii) (*a*) of this subparagraph, "66⅔ percent of the amount of the tax" in subdivision (ii) of this subparagraph, and "6 percent of the excess of the tax" in subdivision (iii) (*b*) of this subparagraph, shall be taken to refer to the lesser of the following: A tax computed under the law applicable to such taxable year without regard to the amendments made by the Individual Income Tax Act of 1944, and a tax computed under the law applicable to such year.

The addition to the tax for substantial underestimate of the estimated tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter of such year in an amount at least as great as though such estimated tax were computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, and on the basis of the tax withheld, and reasonably expected on the date of the filing of the declaration to be withheld, on wages received during the calendar year ending with or within the taxable year, but otherwise as though such estimated tax were computed on

the basis of the net income and the surtax net income shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year. The net income and the surtax net income shown on the taxpayer's return for the preceding taxable year shall be considered to be zero for the purposes of this section if for such year the taxpayer did not file a return and was not required to file a return. In the case of farmers exercising an election under section 60 (a), such addition to the tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within the last quarter of such year in an amount at least as great as though computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, but otherwise as though computed on the basis of the net income and the surtax net income shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year. In the case of a taxable year beginning in 1943, those quarters of the taxable year which began before July 1, 1943, are excluded for the purpose of determining the application of the relief provision under section 294 (d) (2). As used in this paragraph the expression "personal exemption and credit for dependents" shall for taxable years beginning after December 31, 1943, be taken to refer to the normal-tax exemption and surtax exemptions; also for such years, the expression "each quarter" shall be taken to include the period (ending with the 15th day of the first month of the succeeding taxable year) within which the last installment of the estimated tax is required to be paid, and the expression "last quarter" shall mean the period (similarly ending with the 15th day of the first month of the succeeding taxable year) within which farmers exercising an election under section 60 (a) are required to pay the estimated tax.

The application of section 294 (d) (2) for a taxable year beginning in 1943 in the case of taxpayers not entitled to elect under section 60 (a), relating to farmers, may be illustrated by the following examples:

Example (1). A, a professional man, on January 10, 1943, made a return for the calendar year 1942 as the head of a family. On January 14, 1943, the facts making A the head of a family ceased to exist. On September 15, 1943, A filed a declaration of estimated tax on which estimated income and Victory tax for 1943 is shown in the amount of $8,000; estimated income and Victory tax withheld, none; estimated tax $8,000; total payments to collector in March and June, 1943, on account of 1942 tax, $3,044; and an unpaid balance of estimated tax, $4,956. He made payment of the unpaid balance of estimated tax in two installments of $2,478 each on September 15, 1943, and December 15, 1943. As a result of a transaction occurring on December 27, 1943, A received taxable income in an amount which made him subject to a combined normal tax, surtax, and Victory tax for the calendar year 1943 in the amount of $15,000. A's tax at 1943 rates on 1942 income, including $20,000 earned net income, amounts to $6,642, computed as follows:

Gross income shown on return for 1942	$24,624
Less: Deductions	6,724
Net income	$17,900
Less: Personal exemption	500
Income subject to surtax	$17,400
Less: Earned income credit	1,400
Income subject to normal tax	$16,000
Gross income (no Victory tax deductions)	$24,624
Less: Victory tax exemption	624
Victory tax net income	$24,000
Computation of tax:	
Normal tax at 6% on $16,000	$960
Surtax on $17,400	4,782
Victory tax at 3.75 percent on $24,000	900
Estimated tax (computed on basis of 1942 income)	6,642
Less: Payments made on account of 1942 tax	3,044
Balance (½ to be paid on or before Sept. 15, 1943 and ½ on or before Dec. 15, 1943)	3,598

Since the installment which was timely paid within the third quarter of 1943 ($2,478) is at least as great one-half of $3,598, or $1,799, that is, one-half of $6,642 reduced by the amounts paid to the collector, or $3,044 (see section 6 (f) of the Current Tax Payment Act of 1943), and since the installment which was timely paid within the fourth quarter of 1943 is also at least as great as one-half of $3,598, A is not subject to the penalty for underestimating the tax for 1943.

Example (2). C, a single individual, not the head of a family, and with no dependents, received a salary of $5,000 for the calendar year 1942. He had no other income for such calendar year. The only allowable deduction shown on C's income tax return for such

calendar year was $200 for contributions. On September 15, 1943, at which time C's status for personal exemption and dependents had not changed, he filed a declaration of estimated tax for the calendar year 1943. In computing his estimated tax he used the gross income, deductions, and credits shown on his 1942 return, adjusted to conform to the law applicable to 1943, and computed a tax of $1,033.30 at 1943 rates, without regard to section 6 of the Current Tax Payment Act of 1943. Since his salary had been increased to $6,000 per annum on January 1, 1943, he computed his estimated income tax withheld and to be withheld during the entire year on the excess of $6,000 over the exemption for withholding of $624 as $672, at the rate of 5 percent for the first half of the year and at the rate of 20 percent for the second half of the year. C's declaration showed an estimated tax of $361.30 and a balance of estimated tax of zero after taking into account the payments C made to the collector on account of tax for 1942 in the amount of $434.60. He received more income in 1943 than anticipated at the time he filed his declaration for 1943, and his correct tax liability for that year after deducting the amount withheld was $800, without regard to section 6 of the Current Tax Payment Act of 1943. The amount reasonably estimated as tax to be withheld on 1943 income plus the amounts paid to the collector on account of C's tax for 1942 satisfied in full the tax computed on the basis of his 1942 income but under the law and at the rates applicable to 1943, and hence C is not subject to the addition to the tax for substantial underestimate of estimated tax, even though the estimate was less than 80 percent of his tax liability for 1943.

[T. D. 5403, 9 F. R. 11054, as amended by T. D. 5420, 9 F. R. 14478]

NOTE: Treasury Decision 5448, 10 F. R. 3399, provides as follows:

In the application of § 29.294-1, as amended, to taxable years beginning before September 1, 1944, the additions to the tax for failure to file a declaration of estimated tax within the time prescribed, or for underestimate of the estimated tax, shall be computed upon the basis of the tax shown on the return or the tax as finally determined, whichever is the lesser.

§ 29.294-2 *Substantial overestimate of expected carry-backs.* (a) Section 294 (e) provides for an addition to the tax in case the amount of tax the time for payment of which has been extended under section 3779 is substantially in excess of the amount the time for payment of which might properly have been extended. Such addition to the tax is in addition to the interest payable under section 3779 (i), to any other applicable additions to the tax, and to any applicable criminal penalties.

(b) Section 294 (e) provides that if the time for payment of any amount of tax or taxes has been extended under section 3779, there shall be added to such tax or taxes an amount equal to 5 percent of the penalty portion, if any, of the amount to which such extension relates unless the taxpayer establishes to the satisfaction of the Commissioner that, as of the end of the taxable year in which the extension was made, there was reasonable cause to expect that there would be no such penalty portion. If the extension of time under section 3779 relates to more than one tax, any addition to the tax under section 294 (e) will, in the discretion of the Commissioner, be added to any one tax or prorated among two or more of such taxes in any proportion he deems advisable.

(c) The "penalty portion" is the excess of:

(1) The amount to which an extension relates which is not paid by the end of the taxable year in which the extension was made, over

(2) 125 percent of (1) the amount to which such extension relates which is satisfied by applying or crediting thereto a decrease in tax determined in respect of an application for a tentative carry-back adjustment under section 3780, less (2) any amounts assessed in respect of such application which are not so satisfied.

(d) The penalty portion in effect, therefore, is the excess of the amount of tax the time for payment of which was extended over 125 percent of the amount the time for payment of which might properly have been extended. The amount the time for payment of which might properly have been extended is the net amount to which the extension relates which is satisfied by applying or crediting thereto a decrease in tax determined in respect of an application for a tentative carry-back adjustment under section 3780.

(e) Any amount to which an extension under section 3779 relates which is paid prior to the end of the taxable year in which the extension was made shall not be deemed to be an amount the time for payment of which was extended in determining under section 294 (e) whether the amount the time for payment of which was extended was substantially in excess of the amount the time for payment of which might properly have been extended. Interest on any amount so

paid prior to the end of the taxable year in which the extension was made will be payable at the rate of 6 percent per annum.

(f) The computation of the penalty portion and the resulting addition to the tax may be illustrated by the following example:

Example. Corporation X, which came into existence on January 1, 1945 and which keeps its books and makes its tax returns on the calendar year basis, filed a statement under section 3779 on March 15, 1946 extending the time for payment of $855 of its excess profits tax for 1945. The extension was based on an expected unused excess profits credit carry-back from 1946, and no part of the amount to which the extension related was paid prior to the end of 1946. The corporation in fact had an unused excess profits credit for 1946, and on March 31, 1947 it filed an application under section 3780 (a) for a tentative carry-back adjustment with respect to the resulting unused excess profits credit carry-back from 1946. The application showed that the corporation's excess profits tax for 1945 was decreased by $855 as a result of such unused excess profits credit carry-back from 1946. The application likewise showed that the corporation's income tax for 1945 was increased by $400 as a result of the decrease in its excess profits tax for 1945. The Commissioner allowed the application in full on June 29, 1947, and the $400 increase in the corporation's income tax for 1945 was assessed on that date. The $855 decrease in the corporation's excess profits tax for 1945 was applied against the $855 of its excess profits tax for 1945 the time for payment of which had been extended pursuant to the statement filed under section 3779 on March 15, 1946. Since the entire decrease in the corporation's excess profits tax for 1945 was applied against the amount of its excess profits tax for 1945 the time for payment of which had been extended under such statement, the corporation paid the $400 increase in its income tax for 1945 in cash. The penalty portion is $286.25, and the addition to the tax is $14.31. These amounts are computed as follows:

(a) Amount to which extension under section 3779 related which was not paid prior to the end of 1946	$855.00
(b) Amount to which extension under section 3779 related which was satisfied by applying thereto a decrease in tax determined in respect of the application for a tentative carry-back adjustment	855.00
(c) Amount of increase in income tax for 1945 assessed in respect of the application for a tentative carry-back adjustment which was not satisfied by crediting thereto a decrease in tax determined in respect of such application	400.00
(d) Amount of tax the time for payment of which might properly have been extended (item (b) less item (c))	$455.00
(e) 125% of $455	568.75
(f) The penalty portion (item (a) less item (e))	286.25
(g) Addition to the tax (5% of $286.25)	14.31

Since the reduction, attributable to the unused excess profits credit carry-back from 1946, in the aggregate of all of Corporation X's taxes previously determined for taxable years prior to 1946 was only $455, the corporation properly should not have extended under section 3779 the time for payment of an amount greater than $455. The penalty portion accordingly is the excess of the amount the time for payment of which was extended over 125 percent of the amount the time for payment of which might properly have been extended. The above addition to the tax, in the amount of $14.31, will be added to the excess profits tax for 1945 and collected as part of such tax unless Corporation X establishes to the satisfaction of the Commissioner that as of December 31, 1946, there was reasonable cause to expect that there would be no penalty portion. Such addition to the tax will be assessed and collected even though the unused excess profits credit carry-back from 1946 reduces the adjusted excess profits net income for 1945 to zero and thus serves in effect to offset the entire excess profits tax for 1945 which would otherwise be due.

[T. D. 5498, 11 F. R. 2168]

CLAIMS AGAINST TRANSFEREES AND FIDUCIARIES

§ 29.311-1 *Claims in cases of transferred assets.* (a) The amount for which a transferee of the property of a taxpayer is liable, at law or in equity, and the amount of the personal liability of a fiduciary under section 3467 of the Revised Statutes, as amended, in respect of any income tax imposed by chapter 1, whether shown on the return of the taxpayer or determined as a deficiency in the tax, shall be assessed against such transferee or such fiduciary, as the case may be, and collected and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by chapter 1, except as provided in this section. The provisions relating to delinquency in payment after notice and demand and the amount of interest attaching because of such delinquency, the authorization of distraint and proceedings in court for collection, the prohibition of claims for

abatement and claims and suits for refund, the filing of a petition with The Tax Court of the United States, and the filing of a petition for review of The Tax Court's decision, are included in the sections of the Internal Revenue Code (and regulations pertaining thereto) relating to deficiencies in the tax imposed by chapter 1.

(b) The term "transferee" as used in this section includes an heir, legatee, devisee, distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in section 112, and all other classes of distributees.

(c) The period of limitation for assessment of the liability of a transferee or of a fiduciary, referred to in paragraph (a) of this section, is as follows:

(1) In the case of the liability of an initial transferee of the property of the taxpayer, one year after the expiration of the period of limitation for assessment against the taxpayer (see sections 275 to 277, inclusive);

(2) In the case of the liability of a transferee or a transferee of the property of the taxpayer, one year after the expiration of the period of limitation for assessment against the preceding transferee, or three years after the expiration of the period of limitation for assessment against the taxpayer, whichever of the two periods (the 1-year period or the 3-year period) first expires;

(3) If a court proceeding against the taxpayer or last preceding transferee for the collection of the tax or liability in respect thereof, respectively, has been begun within the period of limitation for the bringing of such proceeding, then within one year after the return of execution in such proceeding; and

(4) In the case of the liability of a fiduciary, not later than one year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is the later.

(5) If before the expiration of the time prescribed in section 311 (b) (1), (2), or (3) for the assessment of the liability of a transferee or fiduciary, both the Commissioner and the transferee or fiduciary have consented in writing to the assessment of the liability after such time, the liability may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(d) For the purpose of determining the period of limitation for assessment against a transferee or a fiduciary, if the taxpayer is deceased, or, in the case of a corporation, has terminated its existence, the period of limitation for assessment against the taxpayer shall be the period that would be in effect had the death or termination of existence not occurred.

(e) If a notice of the liability of a transferee or the liability of a fiduciary has been mailed to such transferee or to such fiduciary under the provisions of section 272 (a), then the running of the statute of limitations shall be suspended for the period during which the Commissioner is prohibited from making the assessment in respect of the liability of the transferee or fiduciary (and in any event, if a proceeding in respect of the liability is placed on the docket of The Tax Court, until the decision of The Tax Court becomes final), and for 60 days thereafter.

§ 29.312-1 *Fiduciaries.* (a) As soon as the Commissioner receives notice that a person is acting in a fiduciary capacity, such fiduciary must, except as otherwise specifically provided, assume the powers, rights, duties, and privileges of the taxpayer with respect to income tax imposed by chapter 1. If the person is acting as a fiduciary for a transferee or other person subject to the liability specified in section 311, such fiduciary is required to assume the powers, rights, duties, and privileges of the transferee or other person under that section. The amount of the tax or liability is ordinarily not collectible from the personal estate of the fiduciary but is collectible from the estate of the taxpayer or from the estate of the transferee or other person subject to the liability specified in section 311. The "notice to the Commissioner" provided for in section 312 shall be a written notice signed by the fiduciary and filed with the Commissioner. The notice must state the name and address of the person for whom the fiduciary is acting, and the nature of the liability of such person; that is, whether it is a liability for tax, and, if so, the year or years involved, or a liability at law or in equity of a transferee of property of a taxpayer, or a liability of a fiduciary under

section 3467 of the Revised Statutes, as amended, in respect of the payment of any tax from the estate of the taxpayer. Any such written notice which has been filed with the Commissioner since the enactment of the Revenue Act of 1926 shall be considered as sufficient notice to the Commissioner within the meaning of section 312. Unless there is already on file with the Commissioner satisfactory evidence of the authority of the fiduciary to act for such person in a fiduciary capacity, such evidence must be filed with and made a part of the notice. If the fiduciary capacity exists by order of court, a certified copy of the order may be regarded as such satisfactory evidence. When the fiduciary capacity has terminated, the fiduciary in order to be relieved of any further duty or liability as such, must file with the Commissioner written notice that the fiduciary capacity has terminated as to him, accompanied by satisfactory evidence of the termination of the fiduciary capacity. The notice of termination should state the name and address of the person, if any, who has been substituted as fiduciary.

(b) If the notice of the fiduciary capacity described in the preceding paragraph is not filed with the Commissioner prior to the sending of notice of a deficiency by registered mail to the last known address of the taxpayer (see section 272 (a)), or the last known address of the transferee or other person subject to liability (see section 311), no notice of the deficiency will be sent to the fiduciary. In such a case the sending of the notice to the last known address of the taxpayer, transferee, or other person, as the case may be, will be a sufficient compliance with the requirements of the Internal Revenue Code, even though such taxpayer, transferee, or other person is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence. Under such circumstances, if no petition is filed with The Tax Court of the United States within 90 days after the mailing of the notice (or within 150 days after mailing in the case of such a notice mailed after October 21, 1942, and addressed to a person outside the States of the Union and the District of Columbia) to the taxpayer, transferee, or other person, the tax, or liability under section 311, will be assessed immediately upon the expiration of such 90-day or 150-day period, and demand for payment will be made by the collector. The term "fiduciary" is defined in section 3797 (a) (6) to mean a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(c) This section, relating to the provisions of section 312, shall not be taken to abridge in any way the powers and duties of fiduciaries provided for in other sections of the Internal Revenue Code.

OVERPAYMENTS

§ 29.322-1 *Authority for abatement, credit, and refund of tax.* Authority for the credit and refund of any overpayment of any income tax imposed by chapter 1 is contained in section 322.

Section 273 (j) prohibits the filing of claims for abatement by taxpayers with respect to assessments of income tax imposed by chapter 1.

§ 29.322-2 *Credit and refund adjustments.* Credits or refunds or overpayments may not be allowed or made after the expiration of the statutory period of limitation properly applicable unless prior to the expiration of such period a claim therefor has been filed by the taxpayer. The claim, together with appropriate supporting evidence, must be filed in the office of the collector for the district in which the tax was paid. Where an amount of tax in excess of that properly due has been paid by a withholding agent, the credit or refund for such excess amount shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent. (See section 143 (f).) As to interest in case of credits or refunds, see section 3771, and section 177, United States Judicial Code, as amended by section 615 of the Revenue Act of 1928 and section 808 of the Revenue Act of 1936.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5325, 9 F. R. 368]

§ 29.322-3 *Claims for refund by taxpayers.* (a) Claims by the taxpayer for the refunding of taxes, interest, penalties, and additions to tax erroneously or illegally collected shall be made on Form 843, or on Form 1040 or short Form 1040A, or by the use of Form W-2 (Rev.), or Employee's Optional Form 1040A as provided in this section and should be filed with the collector of internal revenue. A separate claim shall be made for each taxable year or period.

(b) No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period. The claim must set forth in detail and under oath each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof. For taxable years beginning after December 31, 1942, a properly executed return on Form 1040 or short Form 1040A shall, at the election of the taxpayer, constitute a claim for refund or credit within the meaning of section 322 for the amount of the over-payment disclosed by such return. For the purposes of section 322 such claim shall be considered as filed on the date on which such return is considered as filed. An election to treat the return as a claim for refund or credit shall be evidenced by a statement on the return setting forth the amount determined as an overpayment and advising whether such amount shall be refunded to the taxpayer or shall be applied as a credit against the taxpayer's estimated tax for the taxable year immediately succeeding the taxable year for which such return is filed. If the taxpayer elects to have the overpayment shown by his income tax return applied to his estimated tax for his succeeding taxable year, no interest shall be allowed on such overpayment, and the full amount of the overpayment shall be applied as a payment on account of the estimated tax for such year or the instalments thereof. For taxable years beginning in 1943 the tax imposed by chapter 1 includes the amount of any increases under section 6 of the Current Tax Payment Act of 1943, and such increases shall be taken into account in computing the amount of any overpayment for such years. If the taxpayer desires the refund or credit of an amount greater than the overpayment disclosed by his original return, he should file a claim on Form 843. The filing of a properly executed return on Form W-2 (Rev.) or Employee's Optional Form 1040A shall constitute an election by the taxpayer to have the return treated as a claim for refund and such return shall constitute a claim for refund within the meaning of section 322 for the amount of the overpayment shown by the collector's computation of the tax on the basis of the return. For the purposes of section 322 such claim shall be considered as filed on the date on which such return is considered as filed. In any case in which a taxpaper elects to have an overpayment refunded to him he may not thereafter change his election to have the overpayment applied as a payment on account of his estimated tax. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund. With respect to limitations upon the refunding or crediting of taxes, see § 29.322-7.

(c) If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter a refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made in the claim showing that the return was filed by the fiduciary and that the latter is still acting. In such cases, if a refund or interest is to be paid, letters testamentary, letters of administration, or other evidence may be required, but should be submitted only upon the receipt of a specific request therefor. If a claim is filed by a fiduciary other than the one by whom the return was filed, the necessary documentary evidence should accompany the claim. The affidavit may be made by the agent of the person assessed, but in such a case a power of attorney must accompany the claim.

(d) 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.

(e) The Commissioner has no authority to refund on equitable grounds penalties or other amounts legally collected. As to claims for refund of sums

recovered by suit, see §§ 29.322-4 to 29.322-6.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5325, 9 F. R. 368, T. D. 5333, 9 F. R. 2434, T. D. 5425, 10 F. R. 20, T. D. 5680, 13 F. R. 9328]

§ 29.322-4 *Claim for payment of judgment obtained against collector.* (a) A claim for the amount of a judgment against a collector of internal revenue for the recovery of taxes, penalties, or other sums should be made under oath, on Form 843, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment and a certificate of probable cause should be attached to the claim. If the payment of court costs is claimed, an itemized bill of the court costs paid, receipted by the clerk of the court, should also accompany the claim. With respect to the certificate of probable cause, section 989 of the Revised Statutes provides:

SEC. 989. When a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury.

If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

(b) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name, accompanied by two certified copies of the final judgment, and an itemized bill of the court costs paid. A certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, should accompany the claim. (See further § 29.322-3.)

§ 29.322-5 *Claim for payment of judgment obtained in United States district court against the United States.* A claim for the payment of a judgment rendered by a United States district court against the United States representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C. Two certified copies of the final judgment should be attached to the claim. If the judgment specifically provides for the recovery of costs, an itemized bill of such court costs paid, receipted by the clerk of the court, should also accompany the claim. If the case was appealed, two certified copies of the mandate of the appellate court should also be attached to the claim. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

§ 29.322-6 *Claim for payment of judgment obtained in the Court of Claims against the United States.* A claim for the payment of a judgment rendered by the United States Court of Claims against the United States, representing taxes, penalties, or other sums should be made under oath, on Form 843, in duplicate, and filed directly with the Commissioner of Internal Revenue, Washington, D. C., accompanied by a certificate of judgment issued by the clerk of the court and two copies of the printed opinion of the court, if an opinion was rendered. A judgment will not be paid until the period for appeal has expired unless a stipulation, signed by both parties to the suit, waiving the right to appeal, has been filed with the clerk of the court, and two certified copies of such waiver are furnished to the Commissioner.

§ 29.322-7 *Limitations upon the crediting and refunding of taxes paid*—(a) *General rule.* Unless a claim for credit or refund of an overpayment is filed within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, the Commissioner is prohibited from allowing or making a credit or refund of income tax imposed by chapter 1 for such year after both periods have expired. If no return is filed by the tax-

payer, the Commissioner is prohibited from allowing or making a credit or refund of such tax after two years from the time the tax was paid unless before the expiration of such 2-year period a claim therefor is filed. The amount of the credit or refund in any case shall not exceed the portion of the tax paid:

(1) If a return was filed by the taxpayer, and the claim was filed within three years from the time the return was filed, during the three years immediately preceding the filing of the claim.

(2) If a claim was filed, and (i) no return was filed, or (ii) if the claim was not filed within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the filing of the claim.

(3) If no claim was filed and the allowance of credit or refund is made within three years from the time the return was filed by the taxpayer, during the three years immediately preceding the allowance of the credit or refund.

(4) If no claim was filed, and (i) no return was filed or (ii) the allowance of the credit or refund is not made within three years from the time the return was filed by the taxpayer, during the two years immediately preceding the allowance of the credit or refund.

For the purposes of this section, a return filed before the last day prescribed by law for the filing thereof, or an advance payment of any portion of the tax made prior to such date, shall be considered as filed or made on the last day prescribed by law for the filing of such return or the payment of such tax. If the taxpayer elected to pay the tax in installments, such an advance payment shall be considered as made on the last day prescribed for the payment of the first installment, but in all cases the last day prescribed by law for filing the return or paying the tax shall be determined without regard to any extension of time granted the taxpayer for filing the return or paying the tax.

The provisions of this paragraph are subject to the exceptions provided in paragraphs (b), (c), (d), and (e) of this section and in Public Law 828 (80th Congress), approved June 29, 1948, extending to December 31, 1949, the time for filing a claim for credit or refund based upon an overpayment of the tax as a result of the failure to take a war loss deduction in respect of property considered destroyed or seized under section 127 (a) of the Code for a taxable year beginning in 1941 or 1942.

(b) *Limitations in case waiver executed.* If the Commissioner and the taxpayer, within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, whichever period expires the later, have agreed in writing under the provisions of section 276 (b) to extend beyond the period prescribed in section 275 the time within which the Commissioner may make an assessment, then the period within which a claim for credit or refund may be filed, or a credit or refund may be allowed or made if no claim is filed, is the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, and for six months thereafter. The amount of the credit or refund in such case shall not, however, exceed the sum of:

(1) The portion of the tax paid during the two years immediately preceding the execution of the agreement between the Commissioner and the taxpayer, or, if such agreement was executed within three years from the time the return was filed, during the three years immediately preceding the execution of such agreement;

(2) The portion of the tax paid after the execution of the agreement between the Commissioner and the taxpayer and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension theerof; and

(3) The portion of tax paid during the six months immediately following the expiration of the period within which the Commissioner might make an assessment pursuant to the agreement between the Commissioner and the taxpayer or any extension of such agreement.

If any portion of the tax is paid within six months after the expiration of the period within which the Commissioner might make an assessment pursuant to an agreement between the Commissioner and the taxpayer or any extension thereof, and if credit or refund is allowed or made after such payment and before the end of such 6-month period, or if claim for credit or refund is filed after such payment and before the end of such 6-month period, then the limitations on such credit or refund are those set forth

in the preceding provisions of this subparagraph.

Credit or refund may be allowed or made more than six months after the expiration of the period within which the Commissioner might make an assessment pursuant to an agreement between the Commissioner and the taxpayer or any extension thereof (in cases other than those described in the immediately preceding paragraph) only if such credit or refund is allowed or made within six months after the tax was paid or if claim for such credit or refund is filed within six months after such payment. In such case, the amount of the credit or refund shall not exceed the portion of the tax paid during the six months immediately preceding the filing of the claim, or, if no claim was filed, the amount of the credit or refund shall not exceed the portion of the tax paid during the six months immediately preceding the allowance of the credit or refund. The 2-year period provided in section 322 (b) (1) and (2) is not applicable in any case in which the tax was paid after the execution of such an agreement.

If a claim for credit or refund is filed or if credit or refund is allowed or made before the execution of any agreement between the Commissioner and the taxpayer to extend the period within which the Commissioner might make an assessment, the limitations on such credit or refund shall be those specified in paragraph (a) of this section.

The agreement referred to in this subparagraph will not be considered to have been executed until the date it is signed by or for the Commissioner.

(c) *Overpayment on account of bad debts, worthless securities, etc.* If the claim for credit or refund relates to an overpayment on account of:

(1) The deductibility by the taxpayer, under section 23 (k) (1), section 23 (k) (4), or section 204 (c), of a debt as a debt which became worthless, or, under section 23 (g) (2) or (k) (2), of a loss from the worthlessness of a security, or

(2) The effect that the deductibility of a debt or loss described in subparagraph (1) of this paragraph has on the application to the taxpayer of a capital loss carry-over provided in section 117 (e), a net operating loss carry-over provided in section 122 (b), or an unused excess profits credit carry-over provided in section 710 (c) (3),

then in lieu of the 3-year period from the date the return was filed in which the claim may be filed or credit or refund allowed or made, as prescribed in paragraph (a) of this section, the period shall be seven years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for the taxable year for which the claim is made or the credit or refund allowed or made. If the claim for credit or refund relates to an over-payment on account of the effect that the deductibility of a debt or loss described in subparagraph (1) of this paragraph has on the application to the taxpayer of a net operating loss carry-back provided in section 122 (b) or an unused excess profits credit carry-back provided in section 710 (c) (3), such period shall be whichever of the following two periods expires later:

(i) Seven years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for the taxable year of the net operating loss or the unused excess profits credit; or

(ii) The period prescribed in paragraph (e) of this section.

In the case of any claim described in this section the amount of the credit or refund may exceed the portion of the tax paid within the period provided in paragraph (a) or (b) of this section, whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this section. Such a credit or refund can not exceed the sum of the following:

(*a*) The portion, if any, of the tax paid within the period provided in paragraph (a) or (b) of this section, whichever is applicable, and

(*b*) The amount of overpayment due to the deductibility of items described in this paragraph.

The portion of an overpayment due to items described in this paragraph shall be determined by treating the proper deduction of such items as the first adjustment to be made in computing such overpayment.

If claim for credit or refund is not filed within the applicable period described in the preceding paragraph, then credit or refund may be allowed or made only if

claim therefor is filed, or if such credit or refund is allowed or made, within any period prescribed in paragraph (a) or (b) of this section, whichever is applicable, subject to the provisions of paragraph (a) or (b) of this section limiting the amount of credit or refund in the case of a claim filed, or, if no claim was filed, in the case of credit or refund allowed or made within such applicable period as prescribed in paragraph (a) or (b) of this section.

The provisions of section 322 (b) (5) do not apply to an overpayment due to the deductibility of a debt that became partially worthless during the taxable year, but only to an overpayment due to the deductibility of a debt which became entirely worthless during such year.

The provisions of this paragraph with regard to an overpayment caused by the deductibility of a bad debt under section 23 (k) (1), section 23 (k) (4), or section 204 (c) or of a loss from the worthlessness of a security under section 23 (g) (2) or (k) (2) are likewise applicable to an overpayment caused by the effect that the deductibility of such a bad debt or loss has on the application to the taxpayer of a carry-over or of a carry-back.

For the limitation on the allowance of interest for an overpayment where credit or refund is subject to the provisions of section 322 (b) (5), see section 3771 (d).

(d) *Overpayment determined by The Tax Court.* In any case where a person having a right to file a petition with The Tax Court of the United States with respect to a deficiency in income tax imposed by chapter 1 filed such petition within the prescribed time, no credit or refund of the tax for the year to which the deficiency relates shall be allowed or made, and no suit for the recovery of any part of such tax shall be instituted by the taxpayer, subject to the following exceptions:

(1) If The Tax Court finds that the person has overpaid his tax for the year to which the notice of deficiency relates, and the decision of The Tax Court as to the amount overpaid has become final (see section 1140), the overpayment shall be credited or refunded, but no such credit or refund shall be made of any portion of the tax unless The Tax Court determines as part of its decision:

(i) That such portion was paid:

(*a*) Within two years immediately preceding the filing of a claim for credit or refund thereof, the mailing of the notice of deficiency, or the execution of an agreement by both the Commissioner and the taxpayer pursuant to section 276 (b) to extend beyond the time prescribed in section 275 the time within which the Commissioner might assess the tax, whichever event occurs first in point of time, or

(*b*) Within three years immediately preceding the filing of the claim, the mailing of the notice of deficiency, or the execution of the agreement, whichever event occurs first in point of time, if the claim was filed, the notice of deficiency mailed, or the agreement executed within three years from the time the return was filed by the taxpayer, or

(*c*) After the execution of such an agreement and before the expiration of the period within which the Commissioner might make an assessment pursuant to such agreement or any extension thereof, or

(*d*) After the mailing of the notice of deficiency; or

(ii) If such portion of the tax was not paid within the period described in subdivision (i) of this subparagraph, but the notice of deficiency was mailed within seven years from the time prescribed for filing the return (determined without regard to any extension of time for filing such return), or a claim of the type described in paragraph (c) of this section was filed, that such portion of the tax does not exceed the amount of the overpayment attributable to the deductibility of items described in paragraph (c) of this section; or

(iii) If such portion of the tax was not paid within the period described in subdivision (i) of this subparagraph, but the notice of deficiency was mailed within the period prescribed in paragraph (e) of this section for the filing of a claim for credit or refund of an overpayment attributable to a net operating loss carry-back or an unused excess profits credit carry-back, or such a claim was filed, that such portion of the tax does not exceed the amount of the overpayment attributable to the carry-back.

The amount of the overpayment attributable to the deductibility of items described in paragraph (c) of this section or to a carry-back shall be determined under the provisions of paragraphs (c) and (e), respectively, of this section. For the limitation on the allowance of interest for any portion of

an overpayment described in subdivision (ii) or (iii) of this subparagraph, see section 3771 (d) or (e), whichever is applicable.

(2) In the case of a jeopardy assessment made under section 273, if the amount which should have been assessed as determined by a decision of The Tax Court which has become final is less than the amount already collected, the excess payment shall be credited or refunded subject to a determination being made by The Tax Court with respect to the time of payment as stated in subparagraph (1) of this paragraph.

(3) If the amount of the deficiency determined by The Tax Court (in a case where collection has not been stayed by the filing of a bond) is disallowed in whole or in part by the reviewing court, then the overpayment resulting from such disallowance shall be credited or refunded without the making of claim therefor subject to a determination being made by The Tax Court with respect to the time of payment as stated in paragraph (d) (1) of this section. (See section 1146.)

(4) Where the amount collected is in excess of the amount computed in accordance with the decision of The Tax Court which has become final, the excess payment shall be credited or refunded within the period of limitation provided in section 322 (b).

(5) Where an amount is collected after the statutory period of limitation upon the beginning of distraint or a proceeding in court for collection has expired (see § 29.275-2), the taxpayer may file a claim for refund of the amount so collected within the period of limitation provided in section 322 (b). In any such case, the decision of The Tax Court as to whether the statutory period upon collection of the tax expired before notice of the deficiency was mailed shall, when the decision becomes final, be conclusive.

(e) *Overpayment on account of net operating loss carry-backs and unused excess profits credit carry-backs*—(1) *Special period of limitation.* If the claim for credit or refund relates to an overpayment attributable to a net operating loss carry-back, provided in section 122 (b), or to an unused excess profits credit carry-back, provided in section 710 (c) (3), then in lieu of the three-year period from the date the return was filed in which the claim may be filed or credit or refund allowed or made, as prescribed in paragraph (a) of this section, the period shall be whichever of the following two periods expires later:

(i) The period which ends with the expiration of the 15th day of the 39th month following the end of the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back; or

(ii) The period which ends with the expiration of the period prescribed in paragraph (b) of this section within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss or the unused excess profits credit which resulted in the carry-back.

In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in paragraph (a) or (b) of this section, whichever is applicable, to the extent of the amount of the overpayment attributable to the carry-back. Such a credit or refund cannot exceed the sum of the following:

(*a*) The portion, if any, of the tax paid within the period provided in paragraph (a) or (b) of this section, whichever is applicable, and

(*b*) The amount of the overpayment attributable to the carry-back.

The portion of an overpayment attributable to a carry-back shall be determined by treating the net operating loss reduction and the unused excess profits credit adjustment, to the extent that they are increased by the net operating loss carry-back or the unused excess profits credit carry-back, as the first adjustments to be made in computing such overpayment.

If claim for credit or refund is not filed, and if credit or refund is not allowed or made, within the period described in the preceding paragraph, then credit or refund may be allowed or made only if claim therefor is filed, or if such credit or refund is allowed or made, within any period prescribed in paragraph (a) or (b) of this section, whichever is applicable, subject to the provisions of paragraph (a) or (b) of this section, limiting the amount of credit or refund in the case of a claim filed, or if no claim was filed, in the case of credit or refund allowed or made within such applicable period.

In the case of an overpayment of excess profits tax attributable to an un-

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used excess profits credit carry-back which itself is produced, or is increased in amount, by a net operating loss carry-back, such overpayment is to be considered as attributable to the net operating loss carry-back to the extent that there would have been no overpayment of excess profits tax if there had been no net operating loss carry-back. Claim for credit or refund of that portion of the overpayment of excess profits tax which is thus attributable to the net operating loss carry-back may be filed, or credit or refund allowed or made, at any time prior to the expiration of the period within which claim for credit or refund of an overpayment attributable to the net operating loss carry-back may be filed or such credit or refund allowed or made if no claim is filed.

For the limitation on the allowance of interest for an overpayment where credit or refund is subject to the provisions of section 322 (b) (6), see section 3771 (e).

(2) *Barred overpayments.* If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carry-back or to an unused excess profits credit carry-back is otherwise prevented by the operation of any law or rule of law (other than section 3761, relating to compromises), such credit or refund may be allowed or made under the provisions of section 322 (g) if a claim therefor is filed within the period provided in section 322 (b) (6) and subparagraph (1) of this paragraph for filing a claim for credit or refund of an overpayment attributable to a carry-back. Similarly, if the allowance of an application, credit or refund of a decrease in tax determined under section 3780 (b) is otherwise prevented by the operation of any law or rule of law (other than section 3761), such application, credit or refund may be allowed or made if an application for a tentative carry-back adjustment is filed within the period provided in section 3780 (a). Thus, for example, even though the tax liability for a given taxable year has previously been litigated before The Tax Court of the United States, credit or refund of an overpayment may be allowed or made, despite the provisions of section 322 (c), if claim for such credit or refund is filed within the period provided in section 322 (b) (6) subparagraph 1 of this paragraph. In the case of a claim for credit or refund of an overpayment attributable to a carry-back, or in the case of an application for a tentative carry-back adjustment, the determination of any court, including The Tax Court of the United States, in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction and the unused excess profits credit adjustment, and the effect of such deduction or adjustment, to the extent that such deduction or adjustment is affected by a carry-back which was not in issue in such proceeding. The provisions of section 322 (g), however, are not to apply to any taxable year with respect to which the Commissioner and the taxpayer have entered into a closing agreement under section 3760 prior to July 31, 1945, the date of enactment of the Tax Adjustment Act of 1945, in which it is expressly provided that the tax liability for such taxable year is not to be affected by a net operating loss carry-back or by an unused excess profits credit carry-back.

The provisions of section 322 (g) may be illustrated by the following example:

Example. Corporation A, which keeps its books and makes its tax returns on the calendar year basis, filed its income and excess profits tax returns for 1944 on March 15, 1945. The corporation claimed $100,000 as a deduction for depreciation on such returns. The Commissioner asserted that only $60,000 was properly allowable as a deduction for depreciation, and he further asserted that the corporation had realized certain long-term capital gains in 1944 which it improperly failed to include in its gross income. These issues were litigated before The Tax Court of the United States which sustained the Commissioner's determinations with respect to both the deduction for depreciation and the capital gains. Pursuant to the decision of The Tax Court, which became final on December 15, 1946, deficiency judgments were entered for the Commissioner with respect to both the income tax and the excess profits tax of the corporation for the year 1944. In computing the deficiency in excess profits tax, proper adjustment was made by The Tax Court for an unused excess profits credit carry-back from the year 1945 to 1944. The corporation did not appeal The Tax Court's decision. In a decision which became final on May 1, 1947, the Supreme Court decided that gains of the type held taxable as long-term capital gains by The Tax Court in the above proceeding are not subject to tax. The corporation sustained net operating losses in both 1946 and 1947 and had an unused excess profits credit for 1946. The net operating loss sustained by the corporation in 1947, when carried back to 1945, increased the unused excess

profits credit for 1945. If proper claims for credit or refund are filed within the period provided in section 322 (b) (6) and § 29.-322-7 (e) (1), the corporation may be allowed credit or refund of such portions of the overpayments of its income tax, its excess profits tax, and any other tax affected, for 1944 as are attributable to the net operating loss carry-back or unused excess profits credit carry-backs which result from the above losses and unused credits. In computing such overpayments, no adjustment is to be made with respect to the gains held taxable as long-term capital gains by The Tax Court or with respect to any other item, except the net operating loss deduction and the unused excess profits credit adjustment, which entered into the determination of the corporation's income tax and excess profits tax for 1944. The net operating loss deduction and excess profits credit adjustment, however, may be adjusted to the extent that they are affected by a carry-back which was not in issue in the above proceeding before The Tax Court. Likewise, adjustments may be made to reflect the effect of such net operating loss deduction and unused excess profits credit adjustment on any other items which enter into the determination of the tax liability. Thus, for example, any deduction limited by net income or adjusted gross income, such as the deduction for charitable contributions, is to be recomputed on the basis of the net income or adjusted gross income as affected by the carry-back. The portion of the overpayment attributable to the net operating loss carry-back or the unused excess profits credit carry-back is to be determined by treating the net operating loss deduction and the unused excess profits credit adjustment, to the extent that they are increased by a net operating loss carry-back or an unused excess profits credit carry-back, as the first adjustments to be made in computing such overpayment.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5447, 10 F. R. 3079, T. D. 5516, 11 F. R. 5859, T. D. 5645, 13 F. R. 4258, T. D. 5657, 13 F. R. 5877]

§ 29.322-8 *Crediting of accounts of collectors in cases of assessments against several persons covering same liability.* If assessments have been made against several persons covering the same tax liability, and payment of such liability by one or more of such persons has been duly certified to the Commissioner, the Commissioner, for the purpose of temporarily relieving the collector from liability under section 3950, may authorize him to take credit temporarily with respect to the assessments not specifically paid. Such action, however, shall not constitute an abatement and shall not discharge the liability of the persons concerned.

FOREIGN PERSONAL HOLDING COMPANIES

§ 29.331-1 *Definition of foreign personal holding company.* (a) A foreign personal holding company is any foreign corporation (other than a corporation exempt from taxation under section 101) which for the taxable year meets (a) the gross income requirement specified in § 29.331-2, and (b) the stock ownership requirement specified in § 29.331-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 102 or section 500. The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally under section 231 upon foreign corporations, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

§ 29.331-2 *Gross income requirement.* To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 334 (b) as required by section 334 (c) (2) be foreign personal holding company income as defined in section 332:

(a) 60 percent or more; or

(b) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless:

(1) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 331 (a) (2) exists; or

(2) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further

discussion of what constitutes "gross income," see section 22 (a) and §§ 29.22 (a)-1 to 29.22 (a)-20.

§ 29.331-3 *Stock ownership requirement.* (a) To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, referred to in this subpart as "United States group." For such purpose, the ownership of the stock must be determined as provided in section 333 and §§ 29.333 (a)-1 to 29.333 (a)-7, and § 29.333 (b)-1.

(b) In the event of any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

§ 29.332-1 *Foreign personal holding company income.* For the purposes of Supplement P (sections 331 to 340, inclusive) and this part the term "foreign personal holding company income" means the portion of the gross income determined for the purposes of section 331 (a) (1) and § 29.331-2 which consists of the following:

(a) *Dividends.* The term "dividends" includes dividends as defined in section 115 (a) and amounts required to be included in gross income under section 334 (b). See § 29.115-1.

(b) *Interest.* The term "interest" means any amounts, includible in gross income, received for the use of money loaned.

(c) *Royalties.* The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not include rents, or overriding royalties received by an operating company. As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

(d) *Annuities.* The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(e) *Gains from the sale or exchange of stock or securities.* The term "gains from the sale or exchange of stock or securities" as used in section 332 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 332 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Internal Revenue Code), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral royalty, or lease, collateral trust certificates, voting trust certificates, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, and obligations issued by or on behalf of a Government, State, Territory, or political subdivision thereof. In the case of "regular dealers in stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealers in stock or securities" as used in section 332 (b) means corporations with an established place

of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(f) *Gains from futures transactions in commodities.* Gains from futures transactions in commodities include gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, but do not include gains from cash transactions or gains by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. In general, foreign personal holding company income includes gains on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

(g) *Income from estates and trusts.* The income from estates and trusts which is to be included in foreign personal holding company income consists of the income from estates and trusts which is required to be included in the gross income of the corporation under sections 161 to 169, inclusive, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(h) *Amounts received under personal service contracts.* Amounts includible in foreign personal holding company income as amounts received under personal service contracts consist of amounts received pursuant to a contract under which the corporation is to furnish personal services, and amounts received from a sale or other disposition of such a contract, if:

(1) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description in the contract); and

(2) At some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description), as the one to perform such services. For this purpose the stock ownership must be determined as provided in section 333 and § 29.333 (a)-1 to 29.333 (a)-7, and § 29.333 (b)-1.

The application of section 332 (e) may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation, a foreign corporation. The M Corporation enacted into a contract with A under which A was to perform personal services for the person or persons which the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation, in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes foreign personal holding company income.

Example (2). The N Corporation, a foreign corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute foreign personal holding company income.

(i) *Compensation for use of property.* The compensation for the use of, or the right to use, property of the corporation which is to be included in foreign personal holding company income consists of amounts received as compensation (however designated and from whomsoever received) for the use of, or the right to use, property of the corporation in any case in which, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right is obtained directly from the corporation or

by means of a sublease or other arrangement. The property may consist of a yacht, a city residence, a country house, or any other kind of property. See sections 331 (a) (2) and 333 and §§ 29.333 (a)-1 to 29.333 (a)-7, and § 29.333 (b)-1.

(j) *Rents.* The rents which are to be included in foreign personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property, but do not include amounts constituting foreign personal holding company income under section 332 (f) and paragraph (i) of this section. However, rents do not constitute foreign personal holding company income if constituting 50 percent or more of the gross income of the corporation.

§ 29.333 (a)-1 *Stock ownership.* For the purpose of determining whether:

(a) A foreign corporation is a foreign personal holding company, in so far as such determination is based on the stock ownership requirements specified in section 331 (a) (2) and § 29.331-3, or

(b) Amounts received under a personal service contract or from the sale of such a contract constitute foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (e) and paragraph (h) of § 29.332-1, or

(c) Compensation for the use of property constitutes foreign personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 332 (f) and paragraph (i) of § 29.332-1,

stock owned by an individual includes stock constructively owned by him as provided in section 333. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 333 and §§ 29.333 (a)-2 to 29.333 (a)-7, and § 29.333 (b)-1. All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

§ 29.333 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1, stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate, and if such trust or estate owns the entire capital stock of the M Corporation, and if the M Corporation in turn owns the entire capital stock of the N Corporation, then the stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein. See also § 29.333 (a)-6.

§ 29.333 (a)-3 *Family and partnership ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of such determination the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(b) The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in paragraph (a) of § 29.333 (a)-1 is illustrated by the following example:

Example. The M Corporation at some time during the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares		Shares		Shares		Shares		Shares	
An individual	A	100	B	20	C	20	D	20	E	20
His father	AF	10	BF	10	CF	10	DF	10	EF	10
His wife	AW	10	BW	40	CW	40	DW	40	EW	40
His brother	AB	10	BB	10	CB	10	DB	10	EB	10
His son	AS	10	BS	40	CS	40	DS	40	ES	40
His daughter by former marriage (son's half-sister)	ASHS	10	BSHS	40	CSHS	40	DSHS	40	ESHS	40
His brother's wife	ABW	10	BBW	10	CBW	10	DBW	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 333 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

(c) The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in (b) and (c) of § 29.333 (a)-1.

§ 29.333 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this section includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

§ 29.333 (a)-5 *Application of family-partnership and option rules.* The family and partnership rule provided in section 333 (a) (2) and § 29.333 (a)-3 and the option rule provided in section 333 (a) (3) and § 29.333 (a)-4 shall be applied:

(a) For the purpose stated in paragraph (a) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the foreign corporation a foreign personal holding company, or

(b) For the purpose stated in paragraph (b) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such a contract foreign personal holding company income, or

(c) For the purpose stated in paragraph (c) of § 29.333 (a)-1, if, but only if, the effect of such application is to make the compensation for the use of property foreign personal holding company income.

The family and partnership rule and the option rule must be applied independently for each of the purposes stated in § 29.333 (a)-1.

§ 29.333 (a)-6 *Constructive ownership as actual ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.333 (a)-1:

(a) Stock constructively owned by a person by reason of the application of the rule provided in section 333 (a) (1) relating to stock not owned by an individual (see § 29.333 (a)-2) shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 333 (a) (2) (see § 29.333 (a)-3) in order to make another person the constructive owner of such stock, and

(b) Stock constructively owned by a person by reason of the application of the option rule provided in section 333 (a) (3) (see § 29.333 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 333 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 333 (a) (2) in order to make another person the constructive owner of such stock, but

(c) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 333 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

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

Example (1). A is a United States citizen, whose wife, AW, owns all of the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock in the P Corporation.

Under the rule provided in section 333 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation

owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock by the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 333 (a) (2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in § 29.333 (a)–1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example A's father, the constructive owner of the stock of the P Corporation.

Example (*2*). B is a United States citizen who owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, a foreign corporation, owned by C, an individual, who is not related to B.

Under the option rule provided in section 333 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 333 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 333 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 333 (a) (2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

§ 29.333 (a)–7 *Option rule in lieu of family and partnership rule.* If, in determining the ownership of stock for any of the purposes set forth in § 29.333 (a)–1, stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 333 (a) (2) (see § 29.333 (a)–(3) and the option rule provided in section 333 (a) (3) (see § 29.333 (a)–4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

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

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, a foreign corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in § 29.333 (a)–1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owing 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See § 29.333 (a)–6.)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under § 29.333 (a)–6, such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 333 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

§ 29.333 (b)–1 *Convertible securities.* Under section 333 (b), outstanding securities of a foreign corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible

during the taxable year) shall be considered as outstanding stock of the corporation for the purpose of the stock ownership requirement provided in section 331 (a) (2), but only if the effect of such consideration is to make the corporation a foreign personal holding company. Such convertible securities shall be considered as outstanding stock for the purpose of section 332 (e), relating to amounts received under personal service contracts, or of section 332 (f), relating to compensation for the use of property, but only if the effect of such consideration is to make the amounts therein referred to includible under such sections as foreign personal holding company income. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1942, 1943, and 1944, those convertible in 1942 can be properly considered as outstanding stock without so considering those convertible in 1943 or 1944, and those convertible in 1942 and 1943 can be properly considered as outstanding stock without so considering those convertible in 1944. However, the securities convertible in 1943 could not be properly considered as outstanding stock without so considering those convertible in 1942 and the securities convertible in 1944 could not be properly considered as outstanding stock without so considering those convertible in 1942 and 1943.

§ 29.334-1 *Gross income in general for purposes of Supplement P.* For all purposes of Supplement P (sections 331 to 340, inclusive) and the regulations pertaining thereto, the gross income of a foreign corporation shall be computed as if the corporation were a domestic corporation and without regard to the provisions of Supplement I (sections 231 to 238, inclusive) and the regulations pertaining thereto, relating to the taxation of foreign corporations generally. Hence, for such purposes, the gross income includes income from all sources, whether within or without the United States, which is not excluded from gross income by section 22 (b) and the regulations pertaining to that section. The gross income thus includes the interest on bonds, notes, and certificates of indebtedness of the United States, even though owned beneficially by a foreign corporation not engaged in trade or business in the United States, and even though such interest otherwise would come within the exemption provided for in section 3 of the Fourth Liberty Bond Act of July 9, 1918, as amended by section 4 of the Victory Liberty Loan Act of March 3, 1919.

§ 29.334-2 *Additions to gross income for purposes of Supplement P.* If, for any taxable year:

(a) A foreign corporation meets the stock ownership requirement specified in § 29.331-3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(b) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company on which the United States group exists with respect to the second company,

then for the purpose of:

(c) Determining whether the first company meets the gross income requirement specified in § 29.331-2, so as to come within the classification of a foreign personal holding company, and

(d) Determining the undistributed Supplement P net income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies,

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in paragraph (b) of this section there had been distributed by the second company, and received by the shareholders, an amount

which bears the same ratio to the undistributed Supplement P net income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The regulations in this section apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

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

Example (1). The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation year and the taxable year of the Y Corpora- another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1943, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1943. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1943, if it also meets the gross income requirement.

For the purpose of determining whether the X Corporation meets the gross income requirement, the entire undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1943, must be included as a dividend in the gross income of the X Corporation for 1943, since—

(a) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1943) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(b) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(c) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1943, the taxable year in which or with which the taxable year of the Y Corporation ends.

If (after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1943, then the undistributed Supplement P net income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed Supplement P net income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed Supplement P net income of the Y Corporation is not includible in the gross income of the X Corporation.

Example (2). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1943, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1944, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The net income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1943. The undistributed Supplement P net income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1944, since at one time in such fiscal year, or from July 1 to and including September 30, 1943, it meets the stock ownership requirement, and the gross income requirement is also satisfied.

In determining whether the X Corporation constitutes a foreign personal holding company for 1944, a portion of the undistributed Supplement P net income of the Y Corporation for the fiscal year ending June 30, 1944 (3/12 of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(a) The X Corporation was a shareholder in the Y Corporation on September 30, 1943, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(b) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed Supplement P net income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(c) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1944, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed Supplement P net income

of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1943, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example (3). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1943, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1944, no part of the undistributed Supplement P net income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1944, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed Supplement P net income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1943, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed.

If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed Supplement P net income allocable to the minority interest of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example (4). If the Y Corporation in example (1) owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed Supplement P net income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undisputed Supplement P net income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed Supplement P net income. If all three corporations are foreign personal holding companies, the undistributed Supplement P net income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain.

In the event that after the inclusion of the undistributed Supplement P net income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed Supplement P net income, would be determined independently of the income of the Y Corporation and the Z Corporation.

§ 29.336-1 *Supplement P net income.* The term "Supplement P net income" means the gross income as defined in section 334 less the deductions provided in section 23 (computed without regard to the provisions of Supplement I (sections 231 to 238, inclusive)), subject to the qualifications, limitations, and exceptions provided in section 336. In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the net income as so computed is not placed on an annual basis under section 47 (c). In addition to the qualifications, limitations, and exceptions provided in sections 336 (a) and 336 (b) (1), a foreign personal holding company is subject to the provisions of sections 336 (b) (2), 336 (b) (3), and 336 (c), in the computation of its Supplement P net income. Section 336 (b) (3) provides that the net operating loss deduction provided by section 23 (s) shall not be allowed. Section 336 (c) provides the same treatment to foreign personal holding companies with respect to capital gains and losses as ordinary corporations except that no capital loss carry-over from the last taxable year beginning in 1941 is allowed. Under section 336 (b) (2) the aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company shall be allowed only in an amount equal to the rent or other compensation received for the use of, or

the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(a) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(b) That the property was held in the course of a business carried on bona fide for profit; and

(c) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of the undistributed Supplement P net income of a foreign personal holding company to be included in gross income in his individual return (see section 337 and § 29.337-1), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(1) A description of the property;

(2) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(3) The name and address of the person from whom acquired and the date thereof;

(4) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(5) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(6) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(7) A copy of the contract, lease, or rental agreement;

(8) The purpose for which the property was used;

(9) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and net income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(10) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(11) Any other information pertinent to the taxpayer's claim.

§ 29.336-2 *Illustration of computation of Supplement P net income and undistributed Supplement P net income.* The method of computation of the Supplement P net income and undistributed Supplement P net income may be illustrated as follows:

Example. The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1942:

The gross income of the corporation as defined in section 334 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed Supplement P net income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 336 (b) (2). The yearly depreciation on the rented property amounts to $30,000.

Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount under the provisions of sections 117 and 336 (c).

Contributions payment of which is made to or for the use of donees described in section 23 (q), for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing net income under section 21.

Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

The net income for the purposes of computing the Supplement P net income of the corporation (including the distributive share of the undistributed Supplement P net income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rented property are deductible under section 23):

Income (Section 22)

Dividends		$200,000
Interest		10,000
Rent		5,000
Gross income as defined in section 22		215,000
Add:		
Distributive share of undistributed Supplement P net income of the other foreign personal holding company (considered as a dividend)		85,000
Gross income as defined in section 334		300,000

Deductions (Section 23)

Expenses allocable to operation of the rented property	$75,000	
Depreciation of the rented property	30,000	
Ordinary and necessary expenses (office)	10,000	
Contributions (within the 5 percent limitation specified in section 23 (q)	5,000	
		120,000
Net income for purposes of computing Supplement P net income		180,000

The Supplement P net income and the undistributed Supplement P net income of the corporation are $210,875 and $160,875, respectively, computed as follows:

Net income for purposes of computing Supplement P net income			$180,000
Add (see section 336 (b)):			
Contributions deductible in computing net income under section 21		$5,000	
Excess property expenses and depreciation over amount of rent received for use of property ($105,000–$5,000)		100,000	
		105,000	
Deduct (see section 336 (a)):			
Federal income taxes	$59,125		
Contributions within the 15 percent limitation specified in section 336 (a) (2)	15,000		
		74,125	
Net additions under section 336			30,875
Supplement P net income			210,875
Less:			
Basic surtax credit for dividends paid (see section 335)			50,000
Undistributed Supplement P net income			160,875

§ 29.337-1 *Income of foreign personal holding companies taxed to United States shareholders*—(a) Supplement P (sections 331 to 340, inclusive) does not impose a tax on foreign personal holding companies. The undistributed Supplement P net income of such companies, however, must be included in the manner and to the extent set forth in this section, in the gross income of their "United States shareholders," that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships (see section 3797 (a), and estates or trusts other than estates or trusts the gross income of which under chapter 1 includes only income from sources within the United States.

(b) *Amount includible in gross income.* Each United States shareholder, who was a shareholder on the day in the taxable year of the foreign personal holding company which was the last day on which a United States group (see section 331 (a) (2) and § 29.331-3) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received

as a dividend if on such last day there had been distributed by the company and received by the shareholders an amount which bears the same ratio to the undistributed Supplement P net income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) The undistributed Supplement P net income of the foreign personal holding company is includible only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which the United States group existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed Supplement P net income even though the domestic corporation cannot be included within the United States group since, under section 333 (a) (1) and § 29.333 (a)-2, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

(d) 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.

(e) The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above specified portion of the undistributed Supplement P net income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders then the assumed distribution of the stated portion of the undistributed Supplement P net income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

(f) The assumed distribution of the required portion of the undistributed Supplement P net income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation whose taxable year is the calendar year is a foreign personal holding company for 1942, and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1942, and B must return his distributive share as income for the fiscal year ending November 30, 1943. In applying this rule, the date as of which the United States group last existed with respect to the company is

immaterial. Thus, in the foregoing example, if September 30, 1942, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1943, even though September 30, 1942, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

§ 29.337–2 *Credit for obligations of the United States.* (a) Each United States shareholder required to return his distributive share in the undistributed Supplement P net income of a foreign personal holding company for any taxable year is allowed, for purposes of the tax imposed by section 11, 13, 14, 201, 204, 207, or 362, a credit against his net income for his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in section 25 (a) (1) and (2)) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 334 (b) and § 29.334–2. (For reduction of credit for such interest on account of amortizable bond premium, see § 29.125–9.)

(b) For example, the M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 25 (a) (1) and (2). In applying the credit allowable under section 337 (c), the United States shareholders of the M Corporation would be entitled to a credit only for their proportionate shares of the interest received by that company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation, as an actual dividend or as a constructive dividend under section 334 (b).

§ 29.337–3 *Information in return.* The information required by section 337 (d) in the returns of certain United States shareholders relates only to the taxable year of a foreign personal holding company for which is computed such corporation's undistributed Supplement P net income, all or part of which must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax returns required by the Internal Revenue Code of such persons, in the form of a statement attached to the return.

§ 29.337–4 *Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.* Sections 337 (e) and 337 (f) are designed to prevent double taxation with respect to the undistributed Supplement P net income of foreign personal holding companies. The application of such sections may be illustrated by the following examples:

Example (1). The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1942 the M Corporation has an undistributed Supplement P net income of $100,000. A is required to include $75,000 of such income in gross income in his return for the calendar year 1942. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1942 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulated earnings and profits at the close of 1942, and if for the calendar year 1943, the M Corporation had no earnings and profits, but distributed $100,000, the amount so distributed would be tax-free in the hands of both A and B. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1942, the facts otherwise being the same, the distributions in 1943 would be taxable to A, and the taxability of such distributions to B would depend upon the application of section 119 (a) (2) (B), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example (2). In example (1) assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1942, $75,000 as a constructive dividend from the M Corporation, the basis of his stock would be $375,000. After the $75,000 is distributed by the M Corporation tax-free the basis of A's stock, assuming no other changes, would again be $300,000. If A failed to include the $75,000 in gross income in his return as required by the In-

ternal Revenue Code and his failure was not discovered until after the 7-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent tax-free distribution of $75,000 would reduce his basis to $225,000, thus tending to compensate for his failure to include the amount of $75,000 in his gross income. If the undistributed Supplement P net income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

§ 29.338-1 *Information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 338 (a), on the 15th day of each month each individual who on such day is an officer or a director of a foreign corporation which, with respect to its taxable year preceding the taxable year in which such month occurs, was a foreign personal holding company, is required to file with the Commissioner a monthly information return as provided in section 338 (a) and this section.

(2) *Returns for a period exceeding one month.* In the case of a foreign personal holding company which before the close of its taxable year distributed to its shareholders 90 percent or more of its Supplement P net income as defined in section 336, or which has no such net income for such taxable year, the following periods are prescribed with respect to which information returns on Form 957 shall be filed during the following year. The return for the last month of the preceding taxable year shall be filed on the 15th day of the first month following the close of such taxable year. Subsequent returns shall be filed for each 6-month period following the close of such taxable year and shall be filed on the 15th day of the first month following such period. If any change in the stock holdings or in the holdings of securities convertible into stock of the corporation occurs during such periods or if a resolution or plan (including any amendments thereof or supplements thereto) for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock is adopted during such periods a monthly information return must also be filed on the 15th day of the month following each month in which the change occurs or the resolution or plan is adopted. In any case under this paragraph where the date for filing a monthly return coincides with the date for filing the return for a 6-month period only the return for the 6-month period need be filed.

(3) *Returns jointly made.* If two or more officers or directors of a foreign corporation are required to file information returns for any period under section 338 (a) and this section, any two or more of such officers or directors may, in lieu of filing separate returns for such period, jointly execute and file one return.

(b) *Form of return.* The return under section 338 (a) and this section shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section and the instructions on the form, set forth with respect to the preceding period the following information:

(1) Name and address of corporation;

(2) Kind of business in which the corporation is engaged;

(3) Date of incorporation;

(4) The country under the laws of which the corporation is incorporated;

(5) Number of shares and par value of common stock of the corporation outstanding as of the beginning and end of the period;

(6) Number of shares and par value of preferred stock of the corporation outstanding as of the beginning and end of the period, the rate of dividend on such stock and whether such dividend is cumulative or noncumulative;

(7) A description of the convertible securities issued by the corporation, including a statement of the face value of, and rate of interest on, such securities;

(8) The name and address of each shareholder, the class and number of shares held by each, together with any changes in stock holdings during such period;

(9) The name and address of each holder of securities convertible into stock of the corporation, the class, number,

and face value of the securities held by each, together with any changes in the holdings of such securities during the period;

(10) A certified copy of any resolution or plan, and any amendments thereof or supplements thereto, for or in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock; and

(11) Such other information as may be required by the return form.

If a person is required to file a return under section 338 (a) and this section with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(d) *Verification of returns.* All returns required by section 338 (a) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (a) and this section, see section 340.

§ 29.338-2 *Annual information returns by officers and directors of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 338 (b), on the sixtieth day after the close of the taxable year of a foreign personal holding company each individual who on such sixtieth day is an officer or director of the corporation shall file with the Commissioner an annual information return as provided in section 338 (b) and this section.

(2) *Returns jointly made.* If two or more officers or directors of a foreign corporation are required to file annual information returns under section 338 (b) and this section for any taxable year of the corporation, any two or more of such officers or directors may in lieu of filing separate annual returns for such taxable year, jointly execute and file one annual return.

(b) *Form of return.* The return under section 338 (b) and this section shall be made on Form 958, copies of which, upon request, may be procured from any collector. Each officer or director should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Internal Revenue Code.

(c) *Contents of return.* The return shall, in accordance with the provisions of this section and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the following information:

(1) The gross income, deductions and credits, net income, Supplement P net income, and undistributed Supplement P net income of the foreign personal holding company for such taxable year, in complete detail;

(2) The same information with respect to such taxable year which is required by section 338 (a) and § 29.338-1 (c), except that if all the required returns with respect to such year have been filed under section 338 (a) and § 29.338-1, no information under section 338 (b) (2) and this paragraph need be set forth in such annual return; and

(3) Such other information as may be required by the return form.

(d) *Verification of returns.* All returns required by section 338 (b) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 338 (b) and this section, see section 340.

§ 29.338-3 *Time and place of filing returns.* Returns required by section 338 and §§ 29.338-1 and 29.338-2 shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

§ 29.339-1 *Information returns by shareholders of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* On the 15th day of each month each United States shareholder, by or for whom 50 percent or more in value of the outstanding stock of a foreign corporation is owned, directly or indirectly (including, in the case of an individual, stock owned by

members of his family, as defined in section 333 (a) (2), if such foreign corporation with respect to its taxable year preceding the taxable year in which such month occurs was a foreign personal holding company, shall file with the Commissioner an information return as provided in section 339 (a) and this section.

(2) *Returns for a period exceeding one month.* In the case of a foreign personal holding company which before the close of its taxable year distributed to its shareholders 90 percent or more of its Supplement P net income, or which has no such net income for such taxable year, the periods with respect to which information returns under section 339 (a) shall be filed shall be the same as the periods prescribed in § 29.338-1 (a) (2).

(3) *Duplicate returns.* If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 338 (a) and § 29.338-1, such returns shall be considered as returns filed under section 339 (a).

(b) *Form of return.* The return under section 339 (a) and this section shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Internal Revenue Code.

(c) *Contents of return.* (1) The return shall, in accordance with the provisions of this section and the instructions on the form, set forth with respect to the preceding period the same information as required to be shown on that form by section 338 (a) and § 29.338-1 (c).

(2) If a person is required to file a return under section 339 (a) and this section with respect to more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(d) *Verification of returns.* All returns required by section 339 (a) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (a) and this section, see section 340.

§ 29.339-2 *Annual information returns by shareholders of certain foreign corporations*—(a) *Requirement for filing returns*—(1) *General.* Under section 339 (b), on the sixtieth day after the close of the taxable year of a foreign personal holding company, each United States shareholder, by or for whom on such sixtieth day 50 percent or more in value of the outstanding stock of the company is owned, directly or indirectly (including in the case of an individual, stock owned by members of his family as defined in section 333 (a) (2)), shall file with the Commissioner an information return as provided in section 339 (b) and this section.

(2) *Duplicate returns.* If a shareholder in a foreign corporation files, as an officer or director in such corporation, the returns required by section 338 (b) § 29.338-2, such returns shall be considered as returns filed under section 339 (b).

(b) *Form of return.* The return under section 339 (b) and this section shall be made on Form 957, copies of which, upon request, may be procured from any collector. Each shareholder should carefully prepare his return so as to set forth fully and clearly the information called for therein and by the applicable regulations. Returns which have not been so prepared will not be considered as meeting the requirements of the Internal Revenue Code.

(c) *Contents of return.* (1) The return shall, in accordance with the provisions of this section and the instructions on the form, set forth with respect to the taxable year of the foreign personal holding company the same information which is required under section 339 (a), § 29.338-1 (c), and § 29.339-1 (c), except that if all the required returns with respect to such year have been filed under section 339 (a) and § 29.339-1, no return under section 339 (b) and this section is required.

(2) If a person is required to file an annual return under section 339 (b) and this section with respect to more than one foreign personal holding company, a separate return must be filed with respect to each foreign personal holding company.

(d) *Verification of returns.* All returns required by section 339 (b) and this section shall be verified under oath or affirmation in the same manner as prescribed in § 29.51-4.

(e) *Penalties.* For criminal penalties for failure to file the returns required by section 339 (b) and this section, see section 340.

§ 29.339-3 *Time and place of filing returns.* Returns required by section 339 and §§ 29.339-1 and 29.339-2 shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, and will be considered filed within the time or times required by law if, within such time or times, such returns are made and placed in the mails in due course, properly addressed and postage paid, provided they are actually received in the office of the Commissioner of Internal Revenue, Washington, D. C., even though received after such time or times.

REGULATED INVESTMENT COMPANIES

§ 29.361-1 *Definition of a regulated investment company*—(a) *Limitations upon source of income.* Section 361 (b) (1) and (2) provides that at least 90 percent of the corporation's gross income for the taxable year shall be derived from dividends, interest, and gains from the sale or other disposition of stock or securities, and less than 30 percent of the corporation's gross income shall have been derived from the sale or other disposition of stock or securities held for less than three months. As to the definition of the term "corporation", see section 3797 (a) (3). In determining the percentage of the corporation's gross income which has been derived from such sources, a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 117 (h) insofar as applicable.

(b) *Limitations requiring diversification of investments.* (1) Section 361 (b) (3), with respect to diversification of investments, requires, in clause (A), that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the corporation be represented by cash and cash items (including receivables), Government securities, securities of other regulated investment companies, and other securities. For the purpose of this calculation, investments in securities other than Government securities or securities of other regulated investment companies shall be limited in respect of any one issuer to an amount not greater than 5 percent of the value of the total assets of the corporation and to not more than 10 percent of the outstanding voting securities of such issuer. Assuming that at least 50 percent of the value of the total assets of the corporation satisfies these requirements, and that the limiting provisions of clause (B) are not violated, the corporation will satisfy the requirements of section 361 (b) (3), notwithstanding that the remaining assets do not satisfy the diversification requirements of clause (A). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of clauses (A) and (B).

(2) Clause (B) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in clause (A)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers, which the corporation controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers that are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business. The term "controls," "controlled group," and "value" are defined for the purposes of this paragraph in section 361 (b) (3). All other terms used in this section have the same meaning as when used in the Investment Company Act of 1940, or that Act as amended. In determining the value of the investment company's investment in the securities of any one issuer, there shall be

included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 361 (b) (3) or the elimination of such discrepancies will have on the status of a company as a regulated investment company for the purposes of these sections, see section 361 (b) (3). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 361 (b) (3) during the taxable year. Such records shall be kept at all times available for inspection by any authorized officer or employee of the Bureau of Internal Revenue, and shall be retained as long as the contents thereof may become material in the administration of any internal-revenue law.

(3) The requirements as to diversification under section 361 (b) (3) are illustrated by the following examples:

Example (1). Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows: 5 percent in cash, 10 percent in Government securities, 20 percent in the securities of regulated investment companies as defined in section 361, 10 percent in the securities of Corporation A, 15 percent in Corporation B, 20 percent in Corporation C, and the balance, 20 percent, in the securities of various corporations, not exceeding 5 percent of its assets in any one company. Investment Company W owns 15 percent of the voting stock of Corporation C and less than 10 percent of the voting stock of the other corporations, except that it owns all of the voting stock of Corporations A and B. None of the corporations is a member of a controlled group. Investment Company W meets the requirements at the end of its first quarter under section 361 (b) (3). It complies with clause (A) since it has 55 percent of its assets invested as provided in clause (A). It complies with clause (B) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example (2). Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows: 10 percent in cash, 35 percent in Government securities, 7 percent in the securities of Corporation A, 12 percent in Corporation B, 15 percent in Corporation C, and 21 percent in Corporation D. Investment Company V fails to meet the requirements of clause (A) of section 361 (b) (3) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example (3). Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows: 20 percent in cash and Government securities, 5 percent in Corporation A, 10 percent in Corporation B, 25 percent in Corporation C, and the other 40 percent in the securities of miscellaneous corporations, not exceeding 5 percent in any one issuer. Investment Company X owns less than 10 percent of the voting power of all of the corporations, except it owns more than 20 percent of the voting power of Corporations B and C. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of section 361 (b) (3) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example (4). Investment Company Y at the close of the particular quarter has 15 percent of its assets invested in cash and Government securities, 30 percent in Corporation K, a regulated investment company, 10 percent in Corporation A, 20 percent in Corporation B, and the remaining 25 percent in various corporations in none of which is more than 5 percent of its assets invested. Corporation K has 20 percent of its assets invested in Corporation I, and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation B. Investment Company Y is disqualified under clause (B) since more than 25 percent of its assets is considered invested in Corporation B as shown by the following calculation:

Percentage of assets invested directly in Corporation B, 20.

Percentage invested through the controlled group, Y-K-L-B, 2.4, determined as follows: 40 percent of 20 percent of 30 percent=2.4.

Percentage invested in the controlled group, Y-A-B, 3, determined by taking 30 percent of 10 percent.

Total percentage of assets of Investment Company Y invested in Corporation B, 25.4.

Example (5). Investment Company Z at the close of the its first full quarter after October 21, 1942 (the date of enactment of the Revenue Act of 1942) meets the requirements of section 361 (b) (3) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such dis-

tributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company because of such distributions.

(c) *Requirements as to election.* Even if an investment company satisfies the other requirements of section 361 for the taxable year, it will not be considered a regulated investment company for such year within the meaning of Supplement Q unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year. The election shall be made by the taxpayer by computing income as a regulated investment company in its return for the first taxable year to which it desires the election to be applicable. No other method of making such election is permitted. An election once made is irrevocable for the current taxable year and all succeeding taxable years.

§ 29.362-1 *Earnings and profits of a regulated investment company.* In the determination of the earnings and profits of a regulated investment company, such earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its net income for such taxable year. See section 362 (a). Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its net income, its earnings and profits for that year if it is a regulated investment company would be $500,000. However, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the previous year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. For the purpose of the earnings-and-profits concept, it is immaterial whether during the taxable year a regulated investment company is taxable under Supplement Q.

§ 29.362-2 *Method of taxation of regulated investment companies.* If a regulated investment company distributes during the taxable year to its shareholders as taxable dividends other than capital gain dividends an amount not less than 90 percent of its net income for the taxable year computed without regard to net long-term and net short-term capital gains, and complies for such year with the provisions of § 29.362-3 (relating to records required to be kept for the purpose of ascertaining the actual ownership of its outstanding stock), it is taxable upon its Supplement Q net income (as defined in section 362 (b) (1) at the rate of 24 percent of the amount thereof, upon its Supplement Q surtax net income (as defined in section 362 (b) (2) at the rate of 16 percent of the amount thereof, for taxable years beginning before January 1, 1946, and at the rate of 14 percent of the amount thereof for taxable years beginning after December 31, 1945, and upon the excess of any net-long-term capital gain over the sum of the net short-term capital loss and the amount of capital gain dividends (as defined in section 362 (b) (7) paid during the year, at the rate of 25 percent of such excess. If a regulated investment company does not in a particular year distribute as taxable dividends, other than capital gain dividends, to its stockholders at least 90 percent of its net income computed without regard to net long-term and net short-term capital gains, it will, in spite of being classified as a regulated investment company, be taxed in that year as an ordinary corporation (that is, it will be entitled to the dividends received credit, but will not be entitled to the basic surtax credit). The term "taxable dividends" means dividends (as defined in section 115 after the application of section 362 (a)) which are taxable in the hands of such shareholders as are subject to taxation under chapter 1. A taxable dividend is not distributed to its shareholders during the taxable year within the meaning of section 362 (b), unless the dividend is received by the shareholders during the taxable year of the company. See § 29.27 (b)-2, relating to when dividends are considered paid. Due to the provisions in section 362 (a) with respect to the concept of earnings and profits of a regulated investment company, even though such a company has no accumulated earnings and profits if it makes distributions during the taxable year of an amount equal to its net income for that year, regardless of the amount of losses which are not deductible against such net income, it will be allowed a basic surtax credit equal to its net income, and thus not be liable for any income tax for the taxable year provided it otherwise satisfies the requirements of Supplement

Q. The terms "Supplement Q net income," "Supplement Q surtax net income," and "capital gain dividend" are defined in section 362 (b) (1), (2), and (7), respectively.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5517, 11 F. R. 6535]

§ 29.362–3 *Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.* Every regulated investment company shall maintain in the collection district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by these regulations to be demanded from the shareholders. The term "actual owner of stock," as used in this part, includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection, by any authorized officer or employee of the Bureau of Internal Revenue, and shall be retained as long as the contents thereof may become material in the administration of any internal-revenue law. For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 501, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 503. Statements giving such information shall be demanded not later than 30 days after the close of the corporation's taxable year or the approval of this part, whichever is later, as follows:

(a) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(b) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(c) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

§ 29.362–4 *Additional information required in returns of shareholders.* Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 29.362–3 requires the company to demand from its shareholders shall submit as a part of the income tax return required by the Internal Revenue Code of such person a statement showing, to the best of his knowledge and belief:

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 503 (a) (2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 503 and §§ 29.503 (a)–1 to 29.503 (a)–7, and § 29.503 (b)–1; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

When making demand for the written statements required of each shareholder under these regulations, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by this section if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its records required by this part. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this part, or which may be required from time to time by any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for such purpose, shall not be taxable as a regulated investment company.

Nothing in this section shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under sections 147 and 148.

§ 29.362-5 *Method of taxation of shareholders of regulated investment companies.* Shareholders who receive capital gain dividends from a regulated investment company distributed during a taxable year of the regulated investment company for which it is taxable under section 362 (b) shall treat such dividends as gains from the sale or exchange of capital assets held for more than six months. A capital gain dividend is defined in section 362 (b) (7) as any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after the close of its taxable year. If the aggregate amounts so designated with respect to the taxable year is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. Thus, if a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1942, that of a distribution of $500,000 made December 15, 1942, $200,000 constituted a capital gain dividend, amounting to $2 per share, and it was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year and that instead of such excess being $200,000 it was $100,000, then instead of each shareholder having received a capital gain dividend of $2 per share he would have received a capital gain dividend of $1 per share.

EXCHANGES AND DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF SECURITIES AND EXCHANGE COMMISSION

§ 29.371-0 *Terms used.* The following terms are defined in section 373 and when used in this section and §§ 29.371-1 to 29.373-1, shall have the meanings therein assigned to them: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding-company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities." Any other term used in this section and §§ 29.371-1 to 29.373-1, which is defined in the Internal Revenue Code, shall be given the respective definition contained in the Code.

§ 29.371-1 *Purpose and scope of exception.* (a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 112 (a)) and that the entire amount received as a dividend is to be included in gross income (see sections 22 (a) and 115). Exceptions to the general rule are provided in section 112, one of which is that made by section 112 (b) (8) with respect to exchanges, sales, and distributions specifically described in section 371. Section 371 provides the extent to which gain or loss is not to be recognized on an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935. Section 115 (c) provides that a distribution in liquidation of a corporation shall be treated as an exchange, and such a distribution is to

be so treated under the provisions of Supplement R (sections 371 to 373, inclusive). The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding-company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 371 (f).

(b) The requirements for nonrecognition of gain or loss as provided in section 371 are precisely stated with respect to the following four general types of transactions:

(1) The exchange that is provided for in section 371 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 371 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 371 (c), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company.

(4) The transfer that is provided for in section 371 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

(c) Certain rules with respect to the receipt of nonexempt property on an exchange described in section 371 (a) are prescribed in section 371 (e).

(d) These new exceptions to the general rule are to be strictly construed as in the case of the other exceptions in section 112. Unless both the purpose and the specific requirements of Supplement R (sections 371 to 373, inclusive) are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under Supplement R. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, as under the various provisions of section 112, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 371 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 371.

(e) The application of the provisions of Supplement R (sections 371 to 373, inclusive) is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 371 (b), in the reduction of basis of certain property. The provisions of section 372 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of Supplement R shall not be construed or applied in such a way as to defeat this purpose.

§ 29.371-2 *Exchanges of stock or securities solely for stock or securities.* The exchange, without the recognition of gain or loss, that is provided for in section 371 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 371 (a), unless the stock or securities transferred and those received are stock or securities as defined by section 373 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 371 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i. e., a corporation in the same holding-company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 371 (a) apply only to the holder of the stock or securities. However, the transferee corporation

must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 371 (b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 371 (a) if it is within the provisions of section 371 (d), relating to transfers within a system group. For further limitations, see section 371 (f).

§ 29.371-3 *Exchanges of property for property by corporations*—(a) *Application of section 371 (b)*. Section 371 (b) applies only to the transfers specified therein with respect to which section 371 (d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized the subsection is inapplicable and the application of other provisions of the Code must be determined. (See section 371 (g).) If section 371 (b) is applicable, the provisions of section 112 (other than the provisions of paragraph 8 of subsection (b)) are inapplicable, and the conditions under, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), and (e) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 373 (e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 373 (b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 373 (a)) and such order satisfies the requirements of section 371 (f);

(3) The transferor corporation has filed the required consent to the regulations under section 372 (a) (2) (see subsection (f) of this section); and

(4) The entire amount of the gain, as determined under section 111, can be applied in reduction of basis under section 372 (a) (2).

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 373 (e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer,

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 373 (a)) which satisfies the requirements of section 371 (f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding-company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (f) and (g) of this section.

The following, for the purposes of this paragraph and paragraph (d) of this section, are treated as expenditures for property other than nonexempt property:

(5) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(6) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(7) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(d) *Recognition of gain in part; insufficient expenditure or investment in case*

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of nonexempt proceeds. If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 372 (a) (2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 372 (a) (2), then the gain, if any, is recognized but in an amount not in excess of the aggregate of:

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 372 (a) (2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 372 (a) (2).

(f) *Consent to regulations under section 372 (a) (2).* To be entitled to the benefits of the provisions of section 371 (b), a corporation must file with its return for the taxable year in which the transfer occurred a consent to have the basis of its property adjusted under section 372 (a) (2) (see § 29.372-2), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made in duplicate on Form 982A in accordance with these regulations and the instructions on the form or issued therewith.

(g) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the Commissioner, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the Commissioner may specify, and such bond with such surety as the Commissioner may require in an amount not in excess of double the estimated maximum income and excess profits taxes which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

§ 29.371-4 *Distribution solely of stock or securities.* If, without any surrender of his stock or securities as defined in section 373 (f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 371 (c) if it is within the provisions of section 371 (d), relating to transfers within a system group. A distribution is also not within the provisions of section 371 (c) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 371 (f).

§ 29.371-5 *Transfers within system group.* (a) The nonrecognition of gain or loss provided for in section 371 (d) (1) is applicable to an exchange of property for other property (including money and other nonexempt property). In order for any exchange to come within such section, all the parties to the exchange

must be corporations which are members of the same system group. The term "system group" is defined in section 373 (d).

(b) Section 371 (d) (1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 29.371-1, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in Supplement R (sections 371 to 373, inclusive), even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 371 (d) (1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 371 (d) (1) will, because of the basis provisions of section 372 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 371 (d) (1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquistion in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

Example. Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 371 (d) (1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 29.372-5) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(d) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 371 (d) (1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 371 (d) (1) and also may be considered to be within some other provision of section 371, it shall be considered that only the provisions of section 371 (d) (1) apply and that the nonrecognition or gain or loss upon such exchange or distribution is by virtue of that section.

§ 29.371-6 *Sale of stock or securities received upon exchange by members of system group.* Section 371 (d) (2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 371 (d) (1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or

securities and if the sale is otherwise within the provisions of seotion 371 (d) (2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 371 (d) (2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

Example. The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange in which section 371 (d) (1) is applicable the Y Corporation on June 1, 1942, issues to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance is 90,000 and its basis to the X Corporation is $75,000. On December 1, 1942, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all af such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1942. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock only $10,000 is recognized, being the difference between the fair market value of the stock when acquired and the amount for which it was sold, since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities.

If in the above example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 29.371-7 *Exchanges in which money or other nonexempt property is received.* (a) Under section 371 (e) (1), if in any exchange (not within any of the provisions of section 371 (d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 371 (a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then:

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 371 (e) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 29.371-8 *Requirements with respect to order of Securities and Exchange Commission.* The term "order of the Securities and Exchange Commission" is defined in section 373 (a). In addition to the requirements specified in that definition, section 371 (f) provides that the provisions of section 371 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935.

(b) The order shali specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquistion, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

The requirements in paragraphs (a), (b) and (c) of this section were not designed merely to simplify the administration of the provisions of section 371, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is of the essence, and must be met if gain or loss is not to be recognized upon the transaction.

§ 29.371-9 *Nonapplication of other provisions of the Internal Revenue Code.* The effect of section 371 (g) is that an exchange, sale, or distribution which is within section 371 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by Supplement R (sections 371 to 373, inclusive), the purpose being to prevent overlapping of the provisions of such supplement and other provisions of the Internal Revenue Code. In other words, if by virtue of section 371 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 371, regardless of what the result might have been under section 112 if Supplement R had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 372, regardless of what the basis of such property might have been under section 113 if Supplement R had not been enacted. On the other hand, if section 371 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of the Code as if Supplement R had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of the Code as if Supplement R had not been enacted.

§ 29.371-10 *Records to be kept and information to be filed with returns.* (a) Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including:

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another

corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfer any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term "exchange" shall, wherever occurring in this subsection (other than this paragraph), be read as "exchange, expenditure, or investment."

(c) Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including:

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including:

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution.

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including:

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution made in obedience to an order of the Securities and Exchange Commission, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§ 29.372-0 *Basis for determining gain or loss.* Section 113 (a) (17) provides that if property is acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372, prior to its amendment by the Revenue Act of 1942, the basis shall be that provided in such section, prior to its amendment by such act, with respect to such property. If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 372 (other than subsection (a) (2)) after its amendment by such act, the basis shall be that prescribed in such section (after its amendment by such Act) with respect to such property. Section 372 therefore expands section 113 (a) in order to make adequate provisions with respect to the basis of property acquired in a transfer made in obedience to an order of the Securities and Exchange Commission in connection with which the recognition of gain or loss is prohibited by the provisions of section 112 (b) (8) and section 371 with respect to the whole or any part of the property received. In general and except as provided in § 29.372-2, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 29.371-1.

§ 29.372-1 *Basis of property acquired upon exchanges under section 371 (a), 371 (b) (prior to amendment by the Revenue Act of 1942), or 371 (e).* (a) In the case of an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning prior to January 1, 1942, if no part of the gain or loss upon such exchange was recognized under section 371, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 371 (a), or in an exchange of property for property as described in section 371 (b), prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning prior to January 1, 1942, gain to the taxpayer was recognized under section 371 (e), on account of the receipt of money,

the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 371 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 371 (e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 371 (a), or on an exchange of property for property as described in section 371 (b), prior to its amendment by the Revenue Act of 1942 and in a taxable year beginning prior to January 1, 1942, although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 372 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 372 (b).

§ 29.372-2 *Reduction of basis of property by reason of gain not recognized under section 371* (b)—(a) *Introductory.* In addition to the adjustments provided in section 113 (b), and the sections of these regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 372 (a) (2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 371 (b), realized in a taxable year beginning after December 31, 1941. Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 371 (b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under such subsection is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Internal Revenue Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under such subsection, property is not considered as having a basis capable of reduction:

(1) If it is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of such subsection.

(b) *General rule.* Section 372 (a) (2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(1) The first category consists of all property of a character subject to the allowance for depreciation under section 23 (l) which is either in the hands of the transferor immediately after the transfer, or is acquired within 24 months after such transfer by an expenditure or investment resulting in the nonrecognition in whole or in part of gain, under section 371 (b). If any of the property in such category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction

of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(2) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 372 (a) (2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 3760. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982A shall (except as provided in the next sentence) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of the last sentence of section 371 (b).

§ 29.372–3 *Basis of property acquired by corporation under section 371 (a), 371 (b), or 371 (e) as contribution of capital or surplus, or in consideration for its own stock or securities.* If, in connection with an exchange of stock or securities for stock or securities as described in section 371 (a), or an exchange of property for property as described in section 371 (b), or an exchange as described in section 371 (e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 372 (b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 371 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 29. 372–4 *Basis of stock or securities acquired by shareholder upon tax-free distribution under section 371 (c).* Under section 372 (c), if there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 371 (c)

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no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(a) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(b) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of the foregoing provisions stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security so that different values may properly be assigned thereto, will constitute a difference in class. As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see section 372 (d).

§ 29.372-5 *Basis of property acquired under section 371 (d) in transactions between corporations of the same system group.* (a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 371 (d) (1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made.

(b) Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 29.371-5.

(c) An exception to this general rule is provided for in case the property acquired consists of stocks or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

Example. Suppose the A Corporation has property with an adjusted basis of $600,000 and in an exchange in which section 371 (d) (1) is applicable, transfers such property to the B Corporation in exehange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with

a par value and fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Suppose that the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the illustration in the preceding paragraph remain the same. In such case the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, and not the amount established as 500,000/1,000,000ths of $1,100,000, or $550,000.

§ 29.373-1 *Definitions*—(a) *"Order of the Securities and Exchange Commission."* An order of the Securities and Exchange Commission as defined in section 373 (a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938), and must be issued under the authority of section 11 (b) or 11 (e) of the Public Utility Holding Company Act of 1935 to effectuate the provisions of section 11 (b) of such act. In all cases the order must become or have become final in accordance with law; i. e., it must be valid, outstanding, and not subject to further appeal. See further sections 373 (a) and 371 (f). Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

Section 11 (e) of the Public Utility Holding Company Act of 1935 provides:

(e) In accordance with such rules and regulations or order as the Commission may

deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *"Registered holding company," "holding-company system," and "associate company."* (1) Under section 5 of the Public Utility Holding Company Act of 1935 any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. The term "registered holding company" as used in this part means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a) (7) of the Public Utility Holding Company Act of 1935, a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i. e., an electric utility company or a gas utility company as defined by such Act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935. An electric utility company is defined by section 2 (a) (3) of the Public Utility Holding Company Act of 1935 to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale of tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a) (4) of such act to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term "holding-company system" has the meaning assigned to it by section 2 (a) (9) of the Public Utility Holding Company Act of 1935, and hence means any holding company, together with all its subsidiary companies (i. e., subsidiary companies within the mean-

ing of section 2 (a) (8) of such act, which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935. The term "member company" is defined by section 2 (a) (14) of such act to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2 (a) (10) of the Public Utility Holding Company Act of 1935, and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *"Majority-owned subsidiary company."* The term "majority-owned subsidiary company" is defined in section 373 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *"System group."* The term "system group" is defined in section 373 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations and the common parent corporation owns directly at least 90 percent of each class of such stock of at least one of the other corporations; but no corporation is a member of a system group if it is not either a registered holding company or a majority-owned subsidiary company. It is to be observed that while the type of stock which must be at least 90 percent owned for the purpose of this definition (i. e., stock not preferred as to both dividends and assets) may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 373 (c), yet as a general rule both types of ownership tests must be met under section 373 (d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *"Nonexempt property."* The term "nonexempt property" is defined by section 373 (e) to include:

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities (including a continuance of encumbrances subject to which the property was transferred and including the amount of any consideration in the form of evidences of indebtedness owned by the transferor). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example:

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which are acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 373 (a), as amended) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 373 (e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 373 (e) (2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *"Stock or securities."* The term "stock or securities" is defined in section 373 (f) for the purposes of sections 371 to 373, inclusive. As therein defined the term includes voting trust certificates and stock rights or warrants.

TAX OF SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS

§ 29.391-1 *Applicability of Supplement S.* If a personal service corporation (as defined in section 725 and the regulations thereunder) elects not to be subject to the excess profits tax for any taxable year, then Supplement S (sections 391 to 396, inclusive) shall be applicable with respect to each person who was a shareholder of such corporation at the close of the taxable year of the corporation. (See section 725 (b).)

§ 29.392-1 *Undistributed Supplement S net income.* The term "undistributed Supplement S net income" means Supplement S net income (as defined in section 393) minus the amount of dividends paid by the corporation during the taxable year. For the method of computing dividends paid, see subsections (d), (e), (f), (g), (h), and (i) of section 27 and the regulations thereunder.

§ 29.393-1 *Supplement S net income.* (a) The term "Supplement S net income" means the net income as defined in section 21, but computed without the deduction allowed under section 23 (q), minus the sum of the following:

(1) The Federal income tax payable under chapter 1 for the taxable year; and

(2) The amount of contributions or gifts made to or for the use of donees described in section 23 (q) for the purposes therein specified, to an amount which does not exceed 15 percent of the net income of the corporation computed without the benefit of sections 23 (q) and 393 (b).

In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the corporate net income, as defined in section 21, is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under the provisions of section 47 (c).

(b) The deductions allowed under section 393 for contributions or gifts made to or for the use of donees described in section 23 (q) are in lieu of deductions otherwise allowable under section 23 (q) and are allowable only for the taxable year in which such contributions or gifts are actually paid, regardless of when pledged and regardless of the method of accounting employed by the corporation in keeping its books and records.

(c) The provisions of paragraphs (g) and (h) of § 29.23 (o)-1 relating to (1) the statement in returns of the name and address of each organization to which a contribution or gift was made and the amount and the approximate date of the actual payment of the contribution or gift, (2) the substantiation of the claims for deductions when required by the Commissioner, and (3) the basis for calculation of the amount of a contribution or gift which is other than money, are equally applicable to claims for deductions of amounts of contributions or gifts by corporations under section 393.

(d) The method of computing Supplement S net income may be illustrated by the following example:

Example. The X Corporation, a personal service corporation, has for the calendar year 1942 a net income, as connected under chapter 1, of $190,000. The Federal income tax payable under chapter 1 for that year amounts to $76,000. Contributions or gifts payment of which is made during the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified amount to $35,000. The Supplement S

net income of the corporation is $94,000, computed as follows:

Net income under chapter 1		$190,000
Add: Contributions deductible in computing net income under section 21		10,000
Net income computed without the benefit of any deduction for contributions		200,000
Less:		
Federal income tax	$76,000	
Contributions deductible under section 393 (b) (15 percent of $200,000)	30,000	
		$106,000
Supplement S net income		94,000

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7335]

§ 29.394-1 *Taxability of shareholders.* If, by reason of an election under section 725, a personal service corporation is exempt for any taxable year from the excess profits tax imposed under subchapter E of chapter 2, the undistributed Supplement S net income of the corporation shall be treated as a dividend received by those who, at the close of the taxable year of the corporation, were the shareholders of the corporation and as such would have been entitled to receive such income as a dividend had it been distributed at that time. Each such shareholder for his taxable year in which or with which the taxable year of the corporation ends, shall include in his gross income his proportionate share of such undistributed Supplement S net income as though such proportionate share had been received as a dividend on the last day of the taxable year of the corporation. Such amount is to be determined by reference to the interest of the shareholder in the corporation, that is, by reference to the number of shares of stock owned and the relative rights of each class of stock if there are several classes of stock outstanding. Thus, if a personal service corporation has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the holders of the common stock, then the assumed distribution of the undistributed Supplement S net income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

§ 29.394-2 *Credit for interest on obligations of the United States and its instrumentalities.* Each shareholder of a personal service corporation who as of the last day of the taxable year of the corporation is required to include in his gross income his proportionate share of the undistributed Supplement S net income of the corporation shall, for the purpose of the tax imposed by section 11 (normal income tax), section 13 (tax on corporations in general), section 14 (tax on special classes of corporations), section 201 (tax on life insurance companies), section 204 (tax on insurance companies other than life or mutual, and mutual marine insurance companies), section 207 (tax on mutual insurance companies other than life or marine), or section 362 (tax on regulated investment companies), be allowed a credit against net income of his proportionate share of the interest specified in section 25 (a) (1), interest on United States obligations, or section 25 (a) (2), interest on obligations of instrumentalities of the United States, which is included in the gross income of the corporation. (For reduction of credit for such interest on account of amortizable bond premium, see § 29.125-9.)

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5458, 10 F. R. 7336]

§ 29.394-3 *Effect on capital account of personal service corporation.* If the undistributed Supplement S net income of a personal service corporation, or any portion thereof, for any taxable year is required to be included in the gross income of the shareholders, such undistributed Supplement S net income shall, for income tax and excess profits tax purposes, be treated as paid-in surplus or as a contribution to capital, paid in as of the close of such taxable year and the accumulated earnings and profits of the corporation shall be correspondingly reduced.

§ 29.394-4 *Basis of stock in hands of shareholders.* If a shareholder of a personal service corporation is required to include in his gross income his proportionate part of the undistributed Supplement S net income of the corporation, the amount so included shall, for the purpose of adjusting the basis of his stock with respect to such proportionate part, be treated as a distribution actually made by the corporation and as a reinvestment in the corporation by the shareholder. It shall, however, be so treated only to the extent to which such amount is included in the return of the shareholder,

increased or decreased by any adjustment of such amount in the last determination of the tax liability of the shareholder made before the expiration of seven years after the date prescribed by law for the filing of his return.

§ 29.396-1 *Tax of certain shareholders paid by the corporation.* Since a shareholder's proportionate share of the undistributed Supplement S net income of a corporation electing not to be subject to the excess profits tax is taxable to such shareholder, the corporation is required, at the time of filing its income tax return under chapter 1, to pay to the collector an amount equal to the amount that would be required by section 143 (b) or section 144 to be deducted and withheld by the corporation had its undistributed Supplement S net income been actually paid in cash to its shareholders as a divdend on the last day of its taxable year.

INDIVIDUALS WITH GROSS INCOME FROM CERTAIN SOURCES OF $3,000 OR LESS

§ 29.400-1 *Scope and application of Supplement T*—(a) *Calendar years 1942 and 1943.* (1) For the calendar years 1942 and 1943, in lieu of the tax imposed under sections 11 and 12, an individual who makes his return on a cash basis may elect to pay the tax imposed under section 400, if his gross income does not exceed $3,000, and if his gross income consists wholly of one or more of the following: Salary, wages, compensation for personal services, dividends, interest, or annuities. For the purposes of the $3,000 limitation in effect for the calendar years 1942 and 1943, the amount of an individual's gross income shall be determined without subtracting any amount on account of such individual's dependents. For example, A, a single person who is not the head of a family, has a gross income, consisting of salary, of $3,200 for 1942. He has two dependents. For the purpose of the $3,000 limitation, his gross income is $3,200, not $2,430 ($3,200 minus $770), and consequently he may not compute his tax under Supplement T (sections 400 to 404, inclusive). An individual deriving any other kind of income, such as income from the conduct of a business or from a trust of which he is a beneficiary, or gains from the sale or exchange of property, may not compute his tax under Supplement T. If an individual derives income from a partnership of which he is a member or from a trust of which he is a beneficiary, and the partnership or trust previously derived the income distributed to him from, for example, interest, he will be considered to have received income from a partnership or trust, rather than from interest, and consequently will not be entitled to compute his tax under Supplement T.

(2) If the taxable year is the calendar year 1942 or the calendar year 1943, a husband and wife living together on July 1 of such taxable year may file separate returns on Form 1040A, if the gross income of each is from the prescribed sources and does not exceed $3,000, or they may file a single joint return on such form if their combined gross income is from the prescribed sources and does not exceed $3,000. A married person living with husband or wife at any time during the calendar year may not compute the tax under Supplement T if the other spouse makes an income tax return without regard to such Supplement (see § 29.404-1).

(3) If an individual dies before the close of the calendar year, his tax may not be determined under Supplement T. Nor may the tax of the surviving spouse of an individual who has gross income and who dies before the close of the calendar year be determined under Supplement T. (See sections 404 and 47 (g).)

(4) If the taxable year is the calendar year 1942 or the calendar year 1943, the following paragraph is applicable in determining the amount of tax under section 400.

(5) In order to determine the amount of his tax an individual merely ascertains the amount of his gross income, subtracts $385 for each dependent for whom a credit is allowable and refers to the schedule set forth in section 400, as amended by section 104 (a) of the Revenue Act of 1942, to find the amount of his tax. If the taxpayer is the head of a family only by reason of his having one or more dependents, he may subtract from his gross income $385 for all except one of such dependents (see example (4) in § 29.401-1). If the taxpayer is a single person who is not the head of a family, his tax is set forth in the third column of such schedule. If the taxpayer is a married person making a separate return, but not including a taxpayer whose spouse makes a return without regard to Supplement T, the tax is set forth in the fourth column of such schedule. If the taxpayer is (i) a married person whose

spouse has no gross income, (ii) a married person making a joint return, or (iii) the head of a family, the tax is set forth in the fifth column of such schedule. Under such schedule no tax is imposed upon a single person whose gross income, less credit for dependents, does not exceed $525, or upon a married person making a separate return whose gross income (less credit for dependents) does not exceed $650, or upon (i) a married person whose spouse has no gross income, (ii) a married person making a joint return, or (iii) the head of a family, whose gross income (less credit for dependents) does not exceed $1,275.

(b) *Taxable years beginning after December 31, 1943.* (1) For taxable years beginning after December 31, 1943, in lieu of the taxes imposed by sections 11 and 12, an individual may elect to pay the tax imposed by section 400 if his adjusted gross income is less than $5,000, regardless of the sources from which such income is derived and regardless of whether such income is computed on the cash basis or on the accrual basis. The application of this paragraph may be illustrated by the following example:

Example. A is employed at a salary of $4,600 for the calendar year 1945. In addition to his salary he received $750 as reimbursement for expenses incurred in the course of his employment during the calendar year. Such items constitute his sole income for 1945. In such case the gross income is $5,350 but the amount of $750 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1945 is $4,600. Hence, the adjusted gross income being less than $5,000, he may elect to pay his tax for 1945 under Supplement T. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee) there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

(2) For the purposes of determining whether a taxpayer may elect to pay the tax under Supplement T for taxable years beginning after December 31, 1943, the amount of the adjusted gross income is controlling, without reference to the number of exemptions or surtax exemptions, as the case may be, to which the taxpayer may be entitled. Thus, for example, if X has, for 1945 as his only income, a salary of $5,800 and his spouse has no gross income and derives her entire support from X, then X's adjusted gross income is $5,800 (not $5,800 minus $1,000, or $4,800) and he is not, for such year, entitled to pay his tax under Supplement T. If, however, X has for 1945 a salary of $6,000 and incident to his employment he incurs expenses in the amount of $1,200 for travel, meals, and lodging while away from home, the adjusted gross income is $6,000 minus $1,200, or $4,800. In such case his adjusted gross income being less than $5,000, X may elect to pay the tax under Supplement T. If, however, X's wife has adjusted gross income of $200, thus bringing the aggregate adjusted gross income to $5,000 and his wife joins in a joint return, the taxpayer cannot elect to pay the tax under Supplement T.

(3) In the case of husband and wife living together, if their aggregate adjusted gross income is less than $5,000 and each is required to file a return both must, or neither can, elect to pay the tax under Supplement T. If, however, one of such spouses has adjusted gross income of $5,000 or more and the other spouse has adjusted gross income of less than $5,000, the latter spouse may elect to pay the tax under Supplement T provided that the other spouse elects to take the standard deduction provided in section 23 (aa).

(4) These restrictions upon the right of a married person to elect to pay the tax under Supplement T are applicable only if such person is married and living with his spouse on the last day of his taxable year or in the event of the death of his spouse during the taxable year, upon the date of such death. For rules relative to the application of these restrictions, see § 29.23 (aa)-1 (c).

(5) To determine the amount of the tax for a taxable year beginning after December 31, 1943, the individual ascertains the amount of his adjusted gross income, refers to the schedule set forth in section 400 which is applicable to the taxable year, ascertains the income bracket into which such income falls, and, using the number of exemptions (or surtax exemptions) applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions (or surtax exemptions) to which the taxpayer is entitled. Thus, if for 1946 A has adjusted gross income of $4,415 and has three exemptions, including his own exemption, his tax is $481.

(6) If, for a taxable year beginning after December 31, 1943, and before January 1, 1946, the taxpayer and his spouse elect to pay the tax imposed by Supplement T on the basis of a joint return and the return includes income of both husband and wife, the tax determined under the table shall be reduced by 3 percent of the smaller adjusted gross income but in an amount not in excess of $15.

(7) For taxable years beginning after December 31, 1943, the fact that the taxable year is a period of less than 12 months resulting by reason of the death of the taxpayer does not prevent the application of Supplement T in the determination of the tax for such period.

[T. D. 5360, 9 F. R. 4327, as amended, by T. D. 5425, 10 F. R. 21, T. D. 5517, 11 F. R. 6536]

§ 29.401-1 *Rules for application of schedule in section 400*—(a) *Calendar years 1942 and 1943.* (1) For the calendar years 1942 and 1943, the determination of whether a taxpayer is a single person, a married person, or the head of a family, or whether he has a dependent, is to be made as of July 1 of such taxpayer's taxable year.

Example (1). For the calendar year 1942, A, an unmarried person, has a gross income of $2,832 derived wholly from salary and interest. During the first five months of 1942, A's status is that of head of a family, but on July 1, 1942, his status is that of a single person not the head of a family. To determine the tax imposed upon him for the calendar year 1942 under section 400, A refers to column 3 of the schedule (applicable to a single person who is not the head of a family) and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $2,825 to $2,850 is $401. Since $2,832 is within this bracket, A's tax is $401.

Example (2). For the calendar year 1942, B has a gross income of $2,312, derived wholly from salary and dividends, and C, his wife, has gross income of $671, derived wholly from wages and an annuity. On July 1, 1942, they are living together and B is supporting two dependent children, both of whom are under the age of 18. B and C file separate returns under Supplement T. To determine his tax for the calendar year 1942, B subtracts $770 from $2,312, refers to column 4 of the schedule (applicable to married person making separate return), and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $1,525 to $1,550 is $152. Since $1,542 ($2,312 minus $770) is within this bracket, B's tax is $152. To determine her tax for such year, C refers to column 4 of the schedule (applicable to married person making separate return) and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $650 to $675 is $3. Since $671 is within this bracket, C's tax is $3. Under such facts, if B and C file a joint return under Supplement T, their combined gross income is $2,983. To determine their tax, they subtract $770 and refer to column 5 of the schedule (applicable to married person making joint return) and find that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $2,200 to $2,225 is $155. Since $2,213 ($2,983 minus $770) is within this bracket, the combined tax of B and C is $155.

Example (3). For the calendar year 1942, D has a gross income of $1,860, derived wholly from wages. He was married on April 1, 1942, and he and his wife were living together on July 1, 1942. He has no dependents. His wife, who has no gross income in 1942, dies on December 1, 1942. To determine his tax for the calendar year 1942, D refers to column 5 of the schedule (applicable to a married person whose spouse has no gross income), and finds that the tax imposed upon a taxpayer whose gross income falls within the bracket running from $1,850 to $1,875 is $94. Since $1,860 is within this bracket, D's tax is $94.

Example (4). For the calendar year 1942, E has a gross income of $2,965. His wife, who has no gross income in 1942, dies on May 15, 1942, and on July 1, 1942, he is supporting and maintaining a home for two dependent children both of whom are under the age of 18. Since E would not occupy the status of head of a family except for the fact that he maintains a home for such children, no amount may be subtracted from gross income on account of one of such children. To determine his tax for the calendar year 1942, E subtracts only $385 and refers to column 5 of the schedule (applicable to head of family) and finds that the tax in the case of a taxpayer whose gross income falls in the bracket running from $2,575 to $2,600 is $220. Since $2,580 ($2,965 minus $385) is within this bracket, E's tax is $220. If the wife had had gross income, the tax of neither spouse could be determined under Supplement T.

(2) Payments to a wife in the nature of, or in lieu of, alimony which are includible in her gross income under sections (22) (k) and 171 may not be considered as a payment by her husband for the support of any dependent (for definition of husband and wife for purposes of this sentence, see section 3797 (a) (17)).

(b) *Taxable years beginning after December 31, 1943.* (1) The term "number of surtax exemptions" means the number of the exemptions allowed under section 25 (b) as credits for surtax purposes. One surtax exemption is allowed for the taxpayer; one surtax exemption

for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one surtax exemption for each dependent whose gross income is less than $500 for such calendar year. After the number of surtax exemptions is ascertained, the tax under Supplement T is determined by reference to the table contained in section 400 in the column appropriate to such number and on the line appropriate to the taxpayer's adjusted gross income. The term "number of exemptions", which, for taxable years beginning after December 31, 1945, is used instead of the term "number of surtax exemptions," means the number of exemptions allowed under section 25 (b) for such years as credits against net income for the purpose of the normal tax and the surtax imposed by sections 11 and 12. See § 29.25-3.

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

Example (1). A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1945. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and, hence, his adjusted gross income is $4,850. His wife, B, has as her sole income dividends of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1945 on Form 1040, electing not to use the optional return Form W-2 (Rev.). In such case four surtax exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900-$4,950. By referring to the bracket and to the column headed "4" in the tax table, the tax is found to be $613. However, since B has adjusted gross income of $85, such tax must be reduced by 3 percent of $35, or $2.55, thus producing a net tax of $610.45.

Example (2). C, a married man, has as his sole income in 1945 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1945 and is entitled to claim three surtax exemptions. C's income falls within the tax bracket $4,600-$4,650, and hence, with three surtax exemptions his tax is $656. No surtax exemption is allowed with respect to D since D had gross income and a joint return was not filed.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 22, T. D. 5517, 11 F. R. 6536]

§ 29.402-1 *Manner of election to compute tax under Supplement T*—(a) *Calendar years 1942 and 1943.* (1) For the calendar years 1942 and 1943, a taxpayer elects to compute his income tax under Supplement T (section 400 to 404, inclusive) by filing a return of his gross income on Form 1040A, the form prescribed for this Supplement. If a husband and wife both make such an election, they may file a joint return reporting their aggregate gross income or they may file separate returns reporting their respective gross incomes. If they file separate returns, the tax of each shall be computed by reference to the fourth column of the schedule set forth in section 400.

(2) An election under Supplement T once made for the taxable year may not be revoked by an amended return or otherwise, but a new election is allowed for each subsequent taxable year. If for any taxable year the taxpayer makes a return without regard to Supplement T, he may not thereafter elect to have his tax computed under such supplement for that taxable year.

(b) *Taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, the taxpayer elects to pay his income tax under Supplement T either by (1) filing a return of his gross income on Form W-2 (Rev.), prescribed in § 29.51-2, or (2) by filing a return on Form 1040 and electing in such return, in the manner prescribed in § 29.23 (aa)-1 (b), to take the standard deduction provided in section 23 (aa). In the case of husband and wife, if the aggregate gross income of the spouses is less than $5,000, the election may be made by the filing of a return on Form W-2 (Rev.), or by the filing of a return on Form 1040 and electing thereon to take the standard deduction. If one spouse has less than $5,000 gross income and the other spouse has gross income of $5,000 or more and the latter spouse, in filing his or her return, claims the standard deduction provided in section 23 (aa), then the former spouse may file on Form W-2 (Rev.) and such filing shall constitute an election by such spouse to pay the tax imposed under Supplement T. If, however, the spouse with gross income of $5,000 or more, in filing his or her return, does

not elect to take such standard deduction, then the other spouse may not elect to pay the tax imposed by Supplement T.
[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 22]

§ 29.404-1 *Taxpayers to whom Supplement T is applicable*—(a) *Calendar years 1942 and 1943.* For the calendar years 1942 and 1943, the following taxpayers are not entitled to file a return and pay tax under Supplement T:

(1) A nonresident alien individual;

(2) An estate or trust;

(3) An individual who files a return for a period of less than 12 months or for any taxable year other than a calendar year;

(4) An individual who is married and living with husband and wife at any time during the calendar year and whose spouse files an income tax return for such year without regard to Supplement T.

(b) *Taxable years beginning after December 31, 1943.* For taxable years beginning after December 31, 1943, the following taxpayers are ineligible to file a return and pay the tax under Supplement T:

(1) A nonresident alien individual;

(2) A citizen of the United States entitled to the benefits of section 251;

(3) An estate or trust;

(4) An individual who makes a return for a period of less than 12 months on account of a change in the accounting period;

(5) An individual for whom a return is required for a fractional part of a year under section 146 (a).

See section 23 (aa) (4) for provisions making both husband and wife ineligible to elect to pay the tax under Supplement T if either spouse does not elect to take the standard deduction.

[Regs. 111, 8 F. R. 15002, as amended by T. D. 5425, 10 F. R. 22]

ABATEMENT OF TAX

§ 29.421-1 *Abatement of tax for members of armed forces on death.* (a) If an individual dies on or after December 7, 1941, and before January 1, 1948, while in active service as a member of the military or naval forces of the United States or of any of the other United Nations, then:

(1) The tax liability in the case of such individual under chapter 1 for the taxable year in which occurs the date of death is cancelled and if the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment shall be abated and if the amount of such tax is collected (regardless of the date of collection) the amount so collected shall be credited or refunded as an overpayment;

(2) The tax liability in the case of such individual under chapter 1 for any taxable year (ending on or after December 7, 1941) prior to the year in which occurs the date of death during any part of which he was a member of such forces is cancelled and if the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment shall be abated and if the amount of such tax is collected, the amount so collected shall be credited or refunded as an overpayment and if at any time prior to January 1, 1948, the allowance of a credit or refund of an overpayment of such amount is barred (except for the provisions of section 3801) by the operation of any law or rule of law, a credit or refund of the overpayment of such amount may be allowed or made provided claim therefor is filed before January 1, 1949; and

(3) That amount of tax for taxable years preceding those specified in subparagraphs (1) and (2) of this paragraph under chapter 1, or corresponding provisions of prior revenue laws, which remains unpaid as at the date of death shall not be assessed, and if any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, such assessment shall be abated and if the amount of any such unpaid tax is collected subsequent to the date of death, the amount so collected shall be credited or refunded as an overpayment.

(b) If such individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 421 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate incomes of such individual and his spouse, but with

respect to taxable years during which such individual was at no time a member of the military or naval forces of the United States or any of the other United Nations and with respect to taxable years ending before December 7, 1941, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose the separate tax of each spouse shall be the tax computed under chapter 1 before the application of sections 32, 35, and 466 (e), but after the application of section 31, as if such spouse were required to make a separate return, except that each spouse shall be entitled to one-half of the personal exemption allowed on the joint return.

(c) If an individual whose tax is cancelled under section 421 and his spouse filed a joint declaration of estimated tax for the taxable year in which occurs the date of death of such individual, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, according as his legal representative and his spouse may agree. Should they agree to treat the estimated tax paid pursuant to such joint declaration as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of death of such individual.

(d) This section applies only if the death occurs while the individual is in active service. A person is in the active service of the military or naval forces if he is actually serving in such forces, not necessarily in the field or in the theater of war. Personnel in the inactive reserves or on retirement are not in active service. Periods during which a person is absent from duty on account of sickness, wounds, leave, internment by the enemy or other lawful cause are periods of active service.

[T. D. 5305, 8 F. R. 15560, as amended by T. D. 5645, 13 F. R. 4258]

SUBPART E—PERSONAL HOLDING COMPANIES

AUTHORITY: §§ 29.500-1 to 29.508-2 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 29.500-1 to 29.508-2 contained in Regulations 111, 8 F. R. 15220, except as noted following sections affected.

§ 29.500-1 *Surtax on personal holding companies.* (a) Section 500 imposes (in addition to the taxes imposed by chapter 1) a graduated income tax or surtax upon corporations classified as personal holding companies and, under the circumstances specified in section 501 (c), upon an affiliated group of railroad corporations. Corporations so classified are exempt from the surtax on corporations improperly accumulating surplus imposed by section 102, but are not exempt from the other taxes imposed by chapter 1. Unlike the surtax imposed by section 102, the surtax imposed by section 500 applies to all personal holding companies defined as such in section 501 and § 29.501-1, regardless of whether or not they were formed or availed of to accumulate earnings or profits for the purpose of avoiding surtax upon shareholders. The surtax imposed by section 500 is 75 percent of the amount of the undistributed subchapter A net income not in excess of $2,000, and 85 percent of the amount of the undistributed subchapter A net income in excess of $2,000. For the alternative tax where the net long-term gain for any taxable year exceeds the net short-term capital loss, see section 117 (c) and the regulations thereunder.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company under section 501 (not including a foreign personal holding company as defined in section 331) is subject to the tax imposed by section 500 with respect to its income from sources within the United States even though such income is not fixed or determinable annual or periodical income specified in section 231 (a). (See section 119.) The term "personal holding company," as used in subchapter A of chapter 2, does not include a foreign corporation if (1) its gross income from sources within the United States for the period specified in section 119 (a) (2) (B) is less than 50 percent of its total gross income from all sources and (2) all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through other foreign corporations.

§ 29.501-1 *Definition of personal holding company.* (a) A personal holding company is any corporation (other than a corporation specified in section 501 (b)) which for the taxable year meets (1) the gross income requirement specified in

§ 29.501-2, and (2) the stock ownership requirements specified in § 29.501-3. Both requirements must be satisfied and both must be met with respect to each taxable year.

(b) A loan or investment corporation, as defined in section 501 (b) (7), is not taxable as a personal holding company. If, for any prior taxable year (or years) beginning after December 31, 1938, and before January 1, 1942, such a corporation classifies as a personal holding company under section 501 (a), it is not subject to the surtax imposed by section 500 for such taxable year (or years) if it elects, within one year after October 21, 1942, not to be so taxed. The election can be made only by the filing of a notice in writing with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, within such 1-year period, requesting that the exemption granted by section 501 (b) be applied to such prior taxable year (or years) with respect to which the corporation was otherwise subject to surtax as a personal holding company.

§ 29.501-2 *Gross income requirement.* (a) To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year be personal holding company income as defined in section 502:

(1) 80 percent or more; or

(2) 70 percent or more if the corporation has been classified as a personal holding company for any taxable year beginning after December 31, 1936, unless:

(i) A taxable year has intervened since the last taxable year for which it was so classified, during no part of the last half of which the stock ownership requirement specified in section 501 (a) (2) exists; or

(ii) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its personal holding company income was less than 70 percent of its gross income.

(b) In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes "gross income," see section 22 (a) and §§ 29.22 (a)-1 to 29.22 (a)-20.

§ 29.501-3 *Stock ownership requirement.* (a) To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than five individuals. For such purpose, the ownership of the stock must be determined as provided in section 503 and §§ 29.503 (a)-1 to 29.503 (a)-7, and § 29.503 (b)-1.

(b) In the event of any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or whether in the ownership thereof, the conditions existing immediately prior and subsequent to each change must be taken into consideration.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the last half of the taxable year, the phrase "in value" shall, in the light of all of the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

(d) The rules stated in paragraphs (b) and (c) of this section are equally applicable in determining the stock ownership requirement specified in section 502 (e), relating to personal service contracts, and in section 502 (f), relating to the use of corporation property by a shareholder. The stock ownership requirement specified in these sections relates, however, to the stock outstanding at any time during the entire taxable year and not merely during the last half thereof.

§ 29.502-1 *Personal holding company income.* The term "personal holding company income" means the portion of the gross income which consists of the following:

(a) *Dividends.* The term "dividends" includes dividends as defined in section 115 (a), and amounts required to be included in gross income under section 337 (b). See § 29.115-1.

(b) *Interest (other than interest constituting rent).* The term "interest" means any amounts, includible in gross income, received for the use of money loaned except that it does not include interest constituting rent (see paragraph (j) of this section).

(c) *Royalties (other than mineral, oil, or gas royalties).* The term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not include rents, or overriding royalties received by an operating company. As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid.

(d) *Annuities.* The term "annuities" includes annuities only to the extent includible in the computation of gross income. (See section 22 (b) (2).)

(e) *Gains from the sale or exchange of stock of securities.* The term "gains from the sale or exchange of stock or securities" as used in section 502 (b) applies to all gains (including gains from liquidating dividends and other distributions from capital) from the sale or exchange of stock or securities includible in gross income. The term "stock or securities" as used in section 502 (b) includes shares or certificates of stock, or interest in any corporation (including any joint-stock company, insurance company, association, or other organization classified as a corporation by the Internal Revenue Code), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral royalty, or lease, collateral trust certificates, voting trust certificates, stock rights or warrants, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a Government, State, Territory, or political subdivision thereof. In the case of "regular dealers in stock or securities" the term does not include gains derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealer in stock or securities" means corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment.

(f) *Gains from futures transactions in commodities.* Gains from futures transactions in commodities include gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, but do not include gains from cash transactions or gains by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. In general, personal holding company income includes gains on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

(g) *Income from estates and trusts.* The income from estates and trusts which is to be included in personal holding company income consists of the income from estates and trusts which is required to be included in the gross income of the corporation under sections 161 to 169, inclusive, together with the gains derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(h) *Amounts received under personal service contracts.* Amounts includible in personal holding company income as amounts received under personal service contracts consist of amounts received pursuant to a contract under which the corporation is to furnish personal services, and amounts received from a sale

or other disposition of such a contract, if:

(1) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(2) At some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose the stock ownership must be determined as provided in section 503 and §§ 29.503 (a)-1 to 29.503 (a)-7, § 29.503 (b)-1, and paragraph (d) of § 29.501-3.

The application of section 502 (e) may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporaation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example (2). The N Corporation, the entire outstanding capital stock of which is owned by four individuals, is engaged in engineering. The N Corporation entered into a contract with the O Corporation to perform engineering services for the O Corporation, in consideration of which the O Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the O Corporation does not constitute personal holding company income.

(i) *Compensation for use of property.* The compensation for the use of, or the right to use, property of the corporation which is to be included in personal holding company income consists of amounts received as compensation (however designated and from whomsoever received) for the use of, or the right to use, property of the corporation in any case in which, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. The property may consist of a yacht, a city residence, a country house, or any other kind of property. See section 503 and §§ 29.503 (a)-1 to 29.503 (a)-7, § 29.503 (b)-1, and paragraph (d) of § 29.501-3.

(j) *Rents (including interest constituting rent).* The rents which are to be included in personal holding company income consist of compensation, however designated, including charter fees, etc., for the use of, or the right to use, real property, or any other kind of property and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation, but do not include amounts constituting personal holding company income under section 502 (f) and paragraph (i) of this section. However, rents do not constitute personal holding company income if constituting 50 percent or more of the gross income of the corporation.

(k) *Mineral, oil, or gas royalties.* (1) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (i) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (ii) the aggregate amount of deductions allowable for expenses under section 23 (a) (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(2) The term "mineral, oil, or gas royalties" means all royalties, except overriding royalties, received from any interest in mineral, oil, or gas properties. The term "mineral" includes the minerals specified in § 29.23 (m)-1 (d). As used in this paragraph the term "overriding royalties" means amounts received from the sublessee by the operating company which originally leased and

developed the natural resource property in respect of which such overriding royalties are paid.

[Regs. 111, 8 F. R. 15220, as amended by T. D. 5458, 10 F. R. 7336]

§ 29.503 (a)-1 *Stock ownership.* For the purpose of determining whether:

(a) A corporation is a personal holding company, in so far as such determination is based on the stock ownership requirement specified in section 501 (a) (2) and § 29.501-3, or

(b) Amounts received under a personal service contract or from the sale of such a contract constitute personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 502 (e) and paragraph (h) of § 29.502-1, or

(c) Compensation for the use of property constitutes personal holding company income in so far as such determination is based on the stock ownership requirement specified in section 502 (f) and paragraph (i) of § 29.502-1,

stock owned by an individual includes stock constructively owned by him as provided in section 503. For such purpose constructive ownership of stock shall be determined and applied in accordance with the rules provided in section 503 and §§ 29.503 (a)-2 to 29.503 (a)-7, and § 29.503 (b)-1. All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration.

§ 29.503 (a)-2 *Stock not owned by individual.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1, stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered, as being owned proportionately by its shareholders, partners, or beneficiaries. For example, if A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate, and if such trust or estate owns the entire capital stock of the M Corporation, and if the M Corporation in turn owns the entire capital stock of the N Corporation, then the stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein. See also § 29.503 (a)-6.

§ 29.503 (a)-3 *Family and partnership ownership.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of such determination the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

The application of the family and partnership rule in determining the ownership of stock for the purpose set forth in paragraph (a) of § 29.503 (a)-1 is illustrated by the following example:

Example. The M Corporation at some time during the last half of the taxable year had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares		Shares		Shares		Shares		Shares	
An individual	A	100	B	20	C	20	D	20	E	20
His father	AF	10	BF	10	CF	10	DF	10	EF	10
His wife	AW	10	BW	40	CW	40	DW	40	EW	40
His brother	AB	10	BB	10	CB	10	DB	10	EB	10
His son	AS	10	BS	40	CS	40	DS	40	ES	40
His daughter by former marriage (son's half-sister)	ASHS	10	BSHS	40	CSHS	40	DSHS	40	ESHS	40
His brother's wife	ABW	10	BBW	10	CBW	10	DBW	160	EBW	10
His wife's father	AWF	10	BWF	10	CWF	110	DWF	10	EWF	10
His wife's brother	AWB	10	BWB	10	CWB	10	DWB	10	EWB	10
His wife's brother's wife	AWBW	10	BWBW	10	CWBW	10	DWBW	10	EWBW	110
Individual's partner	AP	10								

By applying the statutory rule provided in section 503 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP) 160
B (including BF, BW, BB, BS, BSHS) 160
CW (including C, CS, CWF, CWB) 220
DB (including D, DF, DBW) 200
EWB (including EW, EWF, EWBW) 170

Total, or more than 50 percent 910

Individual A represents the obvious case where the head of the family owns the bulk

of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

The method of applying the family and partnership rule as illustrated in the foregoing example also applies in determining the ownership of stock for the purposes stated in paragraphs (a) and (b) of § 29.503 (a)-1.

§ 29.503 (a)-4 *Options.* In determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1, if any person has an option to acquire stock, such stock may be considered as owned by such person. The term "option" as used in this section includes an option to acquire such an option and each one of a series of such options, so that the person who has an option on an option to acquire stock may be considered as the owner of the stock.

§ 29.503 (a)-5 *Application of family-partnership and option rules.* The family and partnership rule provided in section 503 (a) (2) and § 29.503 (a)-3 and the option rule provided in section 503 (a) (3) and § 29.503 (a)-4 shall be applied:

(a) For the purpose stated in paragraph (a) of § 29.503 (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 paragraph (b) of § 29.503 (a)-1, if, but only if, the effect of such application is to make the amounts received under a personal service contract or from the sale of such a contract personal holding company income, or

(c) For the purpose stated in paragraph (c) of § 29.503 (a)-1, if, but only if, the effect of such application is to make the compensation for the use of the property personal holding company income. The family and partnership rule and the option rule must be applied independently for each of the purposes stated in § 29.503 (a)-1.

§ 29.503 (a)-6 *Constructive ownership as actual ownership.* (a) In determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1:

(1) Stock constructively owned by a person by reason of the application of the rule provided in section 503 (a) (1), relating to stock not owned by an individual (see § 29.503 (a)-2) shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 503 (a) (2) (see § 29.503 (a)-3) in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 503 (a) (3) (see § 29.503 (a)-4) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 503 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 503 (a) (2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 503 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

(b) The application of this section may be illustrated by the following examples:

Example (1). A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation.

Under the rule provided in section 503 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided

in section 503 (a) (2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in § 29.503 (a)-1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example (2). B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B.

Under the option rule provided in section 503 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 503 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 503 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 503 (a) (2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

§ 29.503 (a)-7 *Option rule in lieu of family and partnership rule.* (a) If, in determining the ownership of stock for any of the purposes set forth in § 29.503 (a)-1, stock may be considered as constructively owned by an individual by an application of both the family-partnership rule provided in section 503 (a) (2) (see § 29.503 (a)-3) and the option rule provided in section 503 (a) (3) (see § 29.503 (a)-4) such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

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

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in § 29.503 (a)-1, to determine the stock ownership of B in the M Corporation.

If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. (See § 29.503 (a)-6.)

However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then under § 29.503 (a)-6, such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying both the family-partnership rule and the option rule, the provisions of section 503 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M Corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

§ 29.503 (b)-1 *Convertible securities.* Under section 503 (b), outstanding securities of a corporation, such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation for the purpose of the stock ownership requirement provided in section 501 (a) (2), but only if the effect of such consideration is to make the corporation a personal holding company. Such convertible securities shall be considered as outstanding stock for the purpose of section 502 (e), relating to amounts received under personal service

contracts, or of section 502 (f), relating to compensation for the use of property, but only if the effect of such consideration is to make the amounts therein referred to includible under such sections as personal holding company income. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1942, 1943, and 1944, those convertible in 1942 can be properly considered as outstanding stock without so considering those convertible in 1943 or 1944, and those convertible in 1942 and 1943 can be properly considered as outstanding stock without so considering those convertible in 1944. However, the securities convertible in 1943 could not be properly considered as outstanding stock without so considering those convertible in 1942 and the securities convertible in 1944 could not be properly considered as outstanding stock without so considering those convertible in 1942 and 1943.

§ 29.504-1 *Undistributed subchapter A net income.* The term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505 and § 29.505-1) minus (a) the amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraph (3), relating to the deficit credit, and paragraph (4), relating to the debt credit, thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations), (b) amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and the terms of such indebtedness (see § 29.504-2), (c) dividends paid after the close of the taxable year and before the 15th day of the third month thereafter, if claimed under section 504 (c) in the return, but only to the extent and subject to the limitations contained in that section, and (d) amounts distributed in redemption of preferred stock outstanding prior to January 1, 1934 (including preferred stock subsequently issued in lieu thereof), but only if such distributions are made before January 1, 1944, for taxable years beginning after December 31, 1940, by a corporation specified in section 504 (d). In computing the dividends paid credit for the purposes of subchapter A of chapter 2, the amount allowed under section 504 (c) in the computation of the tax under subchapter A for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of distribution.

§ 29.504-2 *Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934*—(a) *Indebtedness.* (1) The term "indebtedness" means an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount. The term "indebtedness" does not include the obligation of a corporation on its capital stock.

(2) The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer prior to January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of refunding, renewal or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(b) *Amounts used or irrevocably set aside.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid.

As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and, as well, all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions are not permitted.

(c) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.* (1) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

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

(3) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the statutory requirement of reasonableness. To be considered reasonable it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted prior to 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(d) *General.* The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the Commissioner may require in substantiation of the deduction claimed.

[Regs. 111, 8 F. R. 15220, as amended by T. D. 5460, 10 F. R. 7524]

§ 29.504-3 *Retroactive application.* If any distribution, which is a dividend solely by reason of the last sentence of section 115 (a), was made prior to October 21, 1942, by a corporation which, under the revenue law applicable to the taxable year in which the distribution was made, was a personal holding comany, or which, for the taxable year in respect of which it is made under section 504 (c) or section 506 or a corresponding provision of a prior income tax law, was a personal holding company under the law applicable to such taxable year, the corporation is entitled to a dividend paid credit for any taxable year in which, or with respect to which, the distribution was made, provided:

(a) The corporation files with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within one year after October 21, 1942, a claim for the benefit of section 186 of the Revenue Act of 1942, on account of any distribution, which is a dividend by reason of the last sentence in section 115 (a), made before October 21, 1942;

(b) Such claim is accompanied by signed consents made on oath or affirmation on Form 972 as provided in § 29.504-5, by each shareholder to whom the corporation made such distribution agreeing to the inclusion of the amount of such distribution as a taxable dividend in his gross income for the taxable year in which it is made; and

(c) Each such consent filed is accompanied by payment of an amount equal to that which would be required by section 143 (b) or 144 of the applicable revenue law to be deducted and withheld by the corporation if the amount of the distribution to the shareholder had been paid to the shareholder in cash as a dividend.

§ 29.504-4 *Claim for benefit of section 186 of the Revenue Act of 1942*—(a) *General.* A claim for the benefit of section 186 of the Revenue Act of 1942 must be filed within one year after October 21, 1942, claiming credit for any distribution, which is a dividend solely by reason of the last sentence of section 115 (a).

(b) *Form of claim.* The claim for such credit shall be made in duplicate, under oath or affirmation, on Form 973B, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* The claim shall, in accordance with the provisions

of this section and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) Taxable year or years for which the benefit of a credit is claimed;

(3) Amount of distribution which is a dividend solely by reason of the last sentence of section 115 (a) and date of payment thereof;

(4) Amount of distribution previously allowed, if any, as a dividends paid credit, and amount of distribution previously disallowed as a dividends paid credit and for which signed consents accompany the claim;

(5) Whether the corporation was a personal holding company under the law applicable to the taxable year in which the distribution was made or for the taxable year in respect of which it was made under sections 504 (c) or 506 or a corresponding provision of a prior income tax law;

(6) Amount of tax to be eliminated, refunded, or credited; and

(7) Such other information as may be required by the claim form.

§ 29.504-5 *Making and filing of consents.* (a) A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with this part and the instructions on the form or issued therewith and may be made only by or on behalf of the shareholder to whom the corporation made the distribution. In the consent it must be agreed that such distribution shall be included as a taxable dividend in the gross income for the taxable year in which the distribution is made.

(b) A consent may be made at any time not later than one year after October 21, 1942. Within such time the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973B, showing the class and number of shares of each class held at date of dividend payment, amount previously considered taxable, amount previously considered nontaxable, and all other information required by the form.

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

(1) Cash;

(2) United States postal money order;

(3) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(4) A cashier's check of a domestic bank; or

(5) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

(d) The amount of such payment shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

§ 29.504-6 *Overpayments and deficiencies*—(a) *Overpayments.* If, as a result of the application of section 186 of the Revenue Act of 1942, any overpayment is established or determined with respect to the personal holding company tax for any year and a claim is filed within one year after October 21, 1942, for the credit or refund of such overpayment, and if, on October 21, 1942, or within one year thereafter, such credit or refund would otherwise be prevented, then notwithstanding any other provision of law or rule of law (other than section 186 (h) of the Revenue Act of 1942, and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected.

(b) *Deficiencies.* If, as a result of the application of section 186 of the Revenue Act of 1942, a deficiency is established or determined with respect to the personal holding company tax for any year, and if, on the date of the filing of the con-

sents referred to in subsection (e) of that section, or on the date of filing of the claim referred to in subsection (g) (1) of that section, or within one year from the date of filing such consents or claim, as the case may be, the assessment or collection of such deficiency is prevented, then notwithstanding any other provision of law or rule of law, the deficiency shall be assessed and collected if assessment is made within one year from the filing of such consents or claim, as the case may be.

(c) *Amounts not included in shareholder's return.* If a shareholder fails to include in his gross income for the proper taxable year the amount specified in section 186 (g) (2) of the Revenue Act of 1942, such failure shall have the same effect with respect to the deficiency resulting therefrom as is provided in section 272 (f) of the Internal Revenue Code with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

§ 29.505-1 *Subchapter A net income.* (a) The term "subchapter A net income" means, in the case of a domestic corporation, the gross income as defined in section 22 less the deductions provided in section 23 subject to the qualifications, limitations, and exceptions provided in section 505. In the case of a foreign corporation, whether resident or nonresident, which files or causes a return to be filed, the "subchapter A net income" means the net income from sources within the United States (gross income from sources within the United States as defined in section 119 and the regulations thereunder less statutory deductions) subject to the qualifications, limitations, and exceptions provided in section 505. In the case of a foreign corporation, whether resident or nonresident, which files no return the "subchapter A net income" means the gross income from sources within the United States as defined in section 119 and the regulations thereunder less the deductions enumerated in section 505 (a) but without the benefit of any deductions under chapter 1 (see section 233). In the case of a taxable year of less than 12 months on account of a change in the accounting period of the corporation, the subchapter A net income is computed on the basis of the period included in the taxable year, and is not placed on an annual basis under section 47 (c).

(b) The "subchapter A net income" includes interest upon obligations of the United States and obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, except as provided in section 22 (b) (4). The "subchapter A net income" does not include interest on obligations of States or Territories of the United States or any political subdivision thereof or of the District of Columbia or of the possessions of the United States.

(c) The foreign tax credit permitted by section 131 with respect to the taxes imposed by chapter 1 is not allowed with respect to the surtax imposed by section 500. However, the deduction of foreign taxes under section 23 (c) is permitted for the purposes of the surtax even if for the purposes of the corporate tax imposed by chapter 1 a credit for such taxes is taken.

(d) In addition to the qualifications, limitations, and exceptions provided in section 505 (a), a personal holding company is subject to the provisions of section 505 (b), (c), and (d) in the computation of its subchapter A net income. Section 505 (c) provides that the net operating loss deduction provided by section 23 (s) shall not be allowed. Section 505 (d) provides the same treatment to personal holding companies with respect to capital gains and losses as ordinary corporations, except that no capital loss carry-over pursuant to section 117 (e) (2) is allowed from the last taxable year beginning in 1941. Under section 505 (b) the aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (l), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the company shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit; and

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that

the property was necessary to the conduct of the business.

(e) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing its subchapter A net income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(1) A description of the property;

(2) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(3) The name and address of the person from whom acquired and the date thereof;

(4) The name and address of the person to whom leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(5) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(6) Evidence that the rent or other compensation was the highest obtainable and, if none was received, a statement of the reasons therefor;

(7) A copy of the contract, lease or rental agreement;

(8) The purpose for which the property was used;

(9) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and net income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(10) A statement of any reason which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(11) Any other information pertinent to the taxpayer's claim.

§ 29.505-2 *Illustration of computation of subchapter A net income, undistributed subchapter A net income, and surtax.* (a) The method of computation of the subchapter A net income, the undistributed subchapter A net income, and the surtax under subchapter A of chapter 2 may be illustrated as follows:

(1) The following facts exist with respect to the O Corporation, a personal holding company which is on the cash receipts and disbursements basis, for the calendar year 1942:

(i) The net income, as computed under chapter 1, amounts of $190,000.

(ii) Federal income tax imposed by sections 13 and 15 was paid March 15, 1942, in the amount of $17,500.

(2) Contributions or gifts payment of which is made to or for the use of donees described in section 23 (q) for the purposes therein specified amount to $35,000, of which $10,000 is deducted in arriving at the net income under chapter 1.

(3) Rent in the amount of $10,000 was received from the principal shareholder of the corporation for the use of a country estate which had been previously acquired from such shareholder in exchange for its capital stock. The expenses of the corporation allocable to the maintenance and operation of the country estate amount to $30,000. The yearly depreciation on the depreciable property of the estate amounts to $5,000. The corporation has not established its right to claim the entire amount of the expenses and depreciation applicable to the estate as provided in section 505 (b) and § 29.505-1.

(4) Dividends paid by the corporation to its shareholders during the taxable year which are allowable as a credit under section 27 (a) amount to $125,000.

(5) The amount used during the year to pay indebtedness incurred by the corporation prior to January 1, 1934, is $31,250.

(6) On March 1, 1943, the corporation paid its shareholders a taxable dividend of $15,000 and in its return, on Form 1120H, claimed a deduction under section 504 (c) of $12,500, that being 10 percent of the dividends paid during the taxable year 1942.

(b) The subchapter A net income, the undistributed subchapter A net income, and the surtax are computed as follows:

Net income under chapter 1		$190,000
Add:		
Contributions deductible in computing net income under section 21		10,000
Aggregate of expenses and depreciation relating to the country estate in excess of the income derived therefrom		25,000
Net income computed without the benefit of a deduction for contributions and without the benefit of the amount disallowed under section 505 (b)		225,000
Less:		
Federal income tax	$17,500	
Contributions deductible under section 505 (a) (2) (15 percent of $225,000)	33,750	
		51,250
Subchapter A net income		173,750
Less:		
Dividends paid credit	$125,000	
Amount used to pay indebtedness	31,250	
		156,250
Undistributed subchapter A net income before applying section 504 (c)		17,500
Dividends paid March 1, 1943 (subject to limitation in section 504 (c) (3)		12,500
Undistributed subchapter A net income		5,000
Amount taxable at 75 percent (not in excess of $2,000)		2,000
Amount taxable at 85 percent ($5,000 minus $2,000)		3,000
Surtax on $2,000 at 75 percent		1,500
Surtax on $3,000 at 85 percent		2,550
Total surtax		4,050

§ 29.506-1 *Purpose and scope of deficiency dividend credit.* (a) Section 506 provides a method under which, by virtue of dividend distributons, a corporation may, under certain conditions (see § 29.506-3), be relieved from the payment of a deficiency in the surtax imposed by subchapter A of chapter 2, or, if any portion of such deficiency has been paid, may be entitled, under certain conditions (see § 29.506-4), to a credit or refund of such portion. The deficiency must be established in the manner specified in section 506 (a) (1), (2), or (3) or section 506 (b) (1), (2), or (3) and the dividends must be paid on the date so established or within 60 days thereafter. For what constitutes payment of a dividend, see § 29.27 (b)-2.

(b) The benefit of section 506 is not extended to the satisfaction of any interest, additional amounts, or additions to the tax provided by law with respect to the deficiency and such amounts remain payable as if that section had not been enacted. The benefit is denied if the closing agreement, decision of The Tax Court of the United States, or judgment contains a finding that any part of the deficiency is due to fraud with intent to evade the tax, or to a failure to file a timely return without reasonable cause for such failure. See section 506 (f).

§ 29.506-2 *Date when decision by Tax Court or court becomes final and date of closing agreement.* (a) The date upon which a decision by The Tax Court of the United States becomes final is prescribed in section 1140.

(b) The date upon which a judgment of a court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petiton for certiorari if no such petition is duly filed within such time.

(c) The date of the closing agreement, made under section 3760, is the date such agreement is approved by the Secretary, the Under Secretary, or an Assistant Secretary.

§ 29.506-3 *Credit against unpaid deficiency*—(a) *General.* If the amount of a deficiency with respect to the tax imposed by subchapter A of chapter 2 has been established as provided in section 506 (a) (1), (2), or (3), the corporation, under certain circumstances, is entitled to a deficiency dividends credit which, though it may not exceed the amount of the deficiency, is to be applied against the amount of such deficiency and all interest, additional amounts, and additions to the tax provided by law not paid on or before the date when the claim for a deficiency dividends credit is filed under section 506 (d). The amount of the deficiency dividends credit is computed at the rates prescribed in section 506 for the taxable

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year for which the deficiency was established, and the allowance of the credit is subject to the following conditions, qualifications, and limitations:

(1) The corporation is required under section 506 (c), within 30 days after the date of the closing agreement or the date upon which the decision of The Tax Court of the United States or the judgment becomes final, to file a notice of its intention to claim a deficiency dividends credit, which notice shall specify the amount of the credit intended to be claimed;

(2) The corporation is required under section 506 (d), within 60 days after the date of the closing agreement or the date upon which the decision of The Tax Court or judgment becomes final, to file a claim with respect to the credit for deficiency dividends;

(3) The deficiency dividends are required under section 506 (c) to be paid prior to the filing of the claim for a deficiency dividends credit and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under chapter 1 for the year in which paid (see section 27 (i) and must be nonpreferential (see section 27 (h)); and

(4) Under section 506 (a) the deficiency dividends credit shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which is not paid on or before the date of the closing agreement, or the date the decision of The Tax Court or the judgment becomes final, as the case may be.

(b) *Form of notification.* The notice of intention to have dividends considered as deficiency dividends for the purposes of the allowance of credit under section 506 (a) shall be made, under oath or affirmation, on Form 975, copies of which, upon request, may be procured from any collector.

(c) *Contents of notification.* The notification shall, in accordance with the provisions of this section and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The amount of the unpaid deficiency with respect to the tax imposed by subchapter A of chapter 2; how it was established (closing agreement. Tax Court decision or court judgment); the date thereof and the taxable year or years involved;

(4) The amount of the credit intended to be claimed as a deficiency dividends credit; and

(5) Such other information as may be required by the notification form.

(d) *Time and place of filing notification.* The notification required by section 506 (c) (1) and this section shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 30 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or judgment becomes final, as the case may be.

(e) *Claim for deficiency dividends credit.* For claims for deficiency dividends credits, see § 29.506–5.

§ 29.506–4 *Credit or refund of deficiency paid.* If the Commissioner has determined that there is a deficiency with respect to the tax imposed by subchapter A of chapter 2 and the corporation has paid any portion of such asserted deficiency, the corporation under certain circumstances, is entitled to a credit or refund of such deficiency. The amount of the credit or refund is computed at the rates prescribed in section 506 for the taxable year for which the deficiency was established, and the allowance of the credit or refund is subject to the following conditions, qualifications, and limitations:

(a) It must be established that the amount for which credit or refund is sought was the whole or a part of a deficiency at the time when paid, and such fact must be established as provided in section 506 (b) (1), (2), or (3);

(b) The corporation is required under section 506 (d), within 60 days after the date of the closing agreement or the date upon which the decision of The Tax Court of the United States or the judgment becomes final, to file a claim for credit or refund;

(c) The "deficiency dividends" are required under section 506 (c) to be paid prior to the filing of the claim for credit or refund and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation

under chapter 1 for the year in which paid (see section 27 (i)), and must be nonpreferential (see section 27 (h));

(d) The credit or refund shall not exceed the portion of the deficiency (not counting the interest, additional amounts, and additions to the tax, provided by law) which was paid by the corporation;

(e) The credit or refund shall be made as provided in section 322, but without regard to section 322 (b) (relating to the limitations on the allowance of refunds or credits), or section 322 (c) (relating to the effect of petitions to The Tax Court on refunds or credits);

(f) No credit or refund shall be made under section 506 (b) with respect to any amount of tax paid after the date of the closing agreement, or the date the decision of The Tax Court or the judgment becomes final, as the case may be; and

(g) No interest shall be allowed on the credit or refund.

§ 29.506-5 *Claim for deficiency dividends credit or credit or refund*—(a) *General.* A claim for a deficiency dividends credit under section 506 (a), relating to credit against unpaid deficiency and under section 506 (b), relating to credit or refund of deficiency paid, must be filed within 60 days after the date of the closing agreement, or the date upon which the decision of The Tax Court of the United States or judgment becomes final, as the case may be.

(b) *Form of claim.* The claim for a deficiency dividends credit, or credit or refund, shall be made in duplicate, under oath or affirmation, on Form 976, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* There shall be attached to and made a part of the claim a certified copy of the resolution of the board of directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed. In addition the claim shall, in accordance with the provisions of this section and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The amount of the deficiency determined with respect to the tax imposed by subchapter A of chapter 2 and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid, or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and in either case whether it was by closing agreement, Tax Court decision or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date claim for refund was filed, and the date the suit was brought; if established by a Tax Court decision or court judgment a copy thereof shall be attached, together with an explanation of how the decision or judgment became final;

(4) The amount and date of payment of the dividend with respect to which the claim for deficiency dividends credit, or credit or refund, is filed;

(5) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(6) The amount claimed as a deficiency dividends credit; and

(7) Such other information as may be required by the claim form.

(d) *Time and place of filing claim.* The claim required by section 506 (d) and this section shall be filed with the Commissioner of Internal Revenue, Washington, D. C., attention Income Tax Unit, Records Division, within 60 days after the date of the closing agreement, or the date upon which the decision of The Tax Court or judgment becomes final, as the case may be.

§ 29.506-6 *Effect of deficiency dividends on dividends paid credit.* No duplication of credit allowances with respect to any "deficiency dividends" is permitted. If a corporation claims and receives the benefit of the provisions of section 506 of the Internal Revenue Code or section 407 of the Revenue Act of 1938 based upon a distribution of "deficiency dividends," that distribution does not become a part of the basic surtax credit for the purposes of subchapter A of

chapter 2; nor is it made the basis of the 2½-month carry-back credit provided for in section 504 (c).

§ 29.506–7 *Suspension of statute of limitations and stay of collection*—(a) *Suspension of running of statute.* If a corporation files a notification of its intent to have certain dividends considered as "deficiency dividends" as provided in section 506 (c), then the running of the statute of limitations upon the assessment and collection of the established deficiency and all interest, additional amounts, and additions to the tax provided by law, is suspended for a period of two years after the date of the filing of such notification.

(b) *Stay of collection.* The Internal Revenue Code provides that, except in case of jeopardy, the collection of the established deficiency and all interest, additional amounts, and additions to the tax provided by law, is stayed for a period of 30 days subsequent to the final determination of the amount thereof. If within such 30-day period the corporation files with the Commissioner the prescribed notification of intention to seek the benefit of section 506, the collection of the established deficiency, to the extent of the amount of the credit specified by the corporation in such notification if not in excess of the amount allowable under section 506 (a), is, except in cases of jeopardy, stayed for a period of 60 days subsequent to the final determination of the amount thereof. The filing of a claim for a deficiency dividends credit under section 506 (d) effects a further stay of collection of that portion of the established deficiency covered by the claim if not in excess of the amount allowable under section 506 (a), until the date the claim is disallowed (in whole or in part) by the Commissioner. The Code further provides that where collection has been stayed as above indicated no distraint or proceeding in court shall be begun for the collection of the amount stayed during the period for which it is stayed. The Commissioner, notwithstanding the provisions of section 272 (b), may refrain from assessing the subchapter A deficiency (plus interest, additional amounts, and additions to the tax) until the claim for the deficiency dividends credit is disposed of. After such claim is allowed or rejected, either in whole or in part, the entire amount of the deficiency (plus interest, additional amounts, and additions to the tax) will be assessed, if not already assessed. The amount of the claim for the deficiency dividends credit to the extent allowed will be credited against the amount so assessed, and the remainder of the amount assessed will be collected in the usual manner.

§ 29.506–8 *Retroactive application.* For regulations relating to making and filing of the claims and consents referred to in subsections (d) (1) and (g) of section 186 of the Revenue Act of 1942, see §§ 29.504–3, 29.504–4, and 29.504–5.

§ 29.506–9 *Overpayments and deficiencies.* For the refund or credit of any overpayment, and the assessment or collection of any deficiency referred to in section 186 (h) of the Revenue Act of 1942, see § 29.504–6.

§ 29.506–10 *Election to have a certain dividend considered as a deficiency dividend.* Section 506 (j) is designed to be used particularly in those cases where a corporation was a personal holding company for certain taxable years beginning prior to January 1, 1942, and the personal holding company tax has been paid in whole or in part prior to October 21, 1942, for such taxable years. In such a case the corporation may elect to have the amount of a dividend paid within six months after October 21, 1942, to shareholders to whom the distribution is made, considered as a deficiency dividend under the following conditions, qualifications, and limitations:

(a) It must be established by the corporation that its income, upon which the personal holding company tax is imposed, exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year and (2) the earnings and profits of the taxable year (computed as of the close of such year without diminution by reason of any distributions made during the taxable year);

(b) The corporation is required to make an election within six months after October 21, 1942, to have the amount of a dividend paid within such 6-month period treated as a deficiency dividend;

(c) The election must be made by the filing of a claim for credit or refund within such 6-month period;

(d) The dividend must be paid prior to the filing of the claim for credit or

refund and the shareholders to whom the distribution is made must include such distribution as a taxable dividend in their returns for the taxable year in which such distribution is made;

(e) The credit or refund shall be made as provided in section 322, but without regard to section 322 (b) (relating to the limitations on the allowance of refunds or credits), or section 322 (c) (relating to the effect of petitions to The Tax Court of the United States on refunds or credits);

(f) No credit or refund shall be made under section 506 (j), with respect to any amount of tax paid on or after October 21, 1942; and

(g) No interest shall be allowed on the credit or refund.

§ 29.506-11 *Claim for additional credit or refund for prior taxable year*—(a) *General.* A claim for additional credit or refund under section 506 (j), relating to election to have a certain dividend treated as a deficiency dividend, must be filed within six months after October 21, 1942, claiming the benefit of that section by reason of a dividend paid within such 6-month period.

(b) *Form of claim.* The claim for additional credit or refund under this section shall be made in duplicate, on oath or affirmation, on Form 976A, copies of which, upon request, may be procured from any collector.

(c) *Contents of claim.* There shall be attached to and made a part of the claim a certified copy of the resolution of the board of directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed. In addition the claim shall, in accordance with the provisions of this section and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The amount of the personal holding company tax imposed for each of the taxable years involved; if tax paid (in whole or in part), date of payment and amount thereof;

(4) The amount of the income, upon which the personal holding company tax is imposed, in excess of the sum of the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and the earnings and profits of the taxable year (computed as of the close of such year without diminution by reason of any distributions made during the taxable year);

(5) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(6) The date the dividend was paid, the taxable year or years with respect to which such dividend applies, and the amount of the dividend to be apportioned to each taxable year;

(7) The amount claimed as a credit or refund; and

(8) Such other information as may be required by the claim form.

§ 29.506-12 *Effect of election.* If the corporation elects to have a distribution made within six months after October 21, 1942, considered as a deficiency dividend as provided in section 506 (j), and files the claim required by that section:

(a) The credit or refund shall be computed, and credited or refunded without interest, as provided in section 506 (b) and at the rates provided therein or in section 506 (g), as the case may be. However, such credit or refund shall not be allowed with respect to any deficiency attributable, in whole or in part, to fraud with intent to evade the tax or to a failure to file a timely return without reasonable cause for such failure. See section 506 (f). In any case where a dividend is apportioned to more than one taxable year the credit or refund shall be determined for each taxable year on the basis of the amount of the dividend apportioned thereto; and

(b) The dividends paid credit for the taxable year in which paid and for a prior taxable year or years shall be determined in the manner prescribed in section 506 (c) (2).

§ 29.508-1 *Return and payment of tax.* A separate return is required for the surtax imposed by section 500. Such returns shall be made on Form 1120H. In the case of a personal holding company which is a domestic corporation, the return is required to be made within the time provided by section 53 and in the

case of a foreign corporation within the time provided in section 235. The tax shown by the corporation on its return must be paid in the case of a domestic corporation within the time provided in section 56 and in the case of a foreign corporation within the time provided in section 236. The same provisions of law relating to the period of limitations for assessment and collection which govern the taxes imposed by chapter 1 also apply to the surtax imposed under subchapter A of chapter 2. However, since the surtax imposed under subchapter A of chapter 2 is a distant and separate tax from those imposed under chapter 1, the making of a return under chapter 1 will not start the period of limitations for assessment of the surtax imposed under subchapter A of chapter 2. If the corporation subject to section 500 fails to file a return the tax may be assessed at any time. If the Commissioner finds a deficiency in respect of the tax imposed by section 500, he is required to follow the same procedure which applies to deficiencies in income tax under chapter 1. The penalties applicable to the income taxes imposed under chapter 1, as well as the provisions of chapter 1 relating to interest and additions to the tax, also apply to the surtax imposed by section 500. The administrative provisions applicable to the surtax imposed by section 500 are not confined to those contained in chapter 1 but embrace all administrative provisions of law which have any application to income taxes.

§ 29.508-2 *Determination of tax, assessment, collection.* The determination, assessment, and collection of the tax imposed by section 500, and the examination of returns and claims in connection therewith, will be made under such procedure as may be prescribed from time to time by the Commissioner.

SUBPART F—DEFINITIONS

AUTHORITY: §§ 29.3797-1 to 29.3797-11 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 29.3797-1 to 29.3797-11 contained in Regulations 111, 8 F. R. 15232, except as noted following section affected.

§ 29.3797-1 *Classification of taxables.* For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See § 29.3797-3.) The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See § 29.3797-4.) The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. (See §§ 29.3797-2 and 29.3797-4.) The definitions, terms, and classifications, as set forth in section 3797, shall have the same respective meaning and scope in this part.

§ 29.3797-2 *Association.* The term "association" is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an inter-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 Code, a trust or an estate, or a partnership. An "investment" trust of the type commonly known as a management trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders. See *Commissioner* v. *North American Bond Trust,* 122 F. (2d) 545, cert. denied 314 U. S. 701. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

[Regs. 111, 8 F. R. 15232, as amended by T. D. 5468, 10 F. R. 9947]

§ 29.3797-3 *Association distinguished from trust.* (a) The term "trust," as used in the Internal Revenue Code, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the 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.

(b) As distinguished from the ordinary trust described in paragraph (a) of this section there is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages. The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted.

(c) If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Internal Revenue Code as a corporation. However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association.

(d) By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form itself. The Internal Revenue Code disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to the essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

(e) The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel

of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

§ 29.3797-4 *Partnerships.* The Internal Revenue Code provides its own concept of a partnership. Under the term "partnership" it includes not only a partnership as known at common law, but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. On the other hand the Code classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation. As to the characteristics of an association, see also §§ 29.3797-2 and 29.3797-3. The following examples will illustrate some phases of these distinctions:

(a) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Code as a partnership.

(b) A, B, and C contribute $10,000 each for the purpose of buying and selling real estate. If A, B, C, or D, an outside party (or any combination of them as long as the approval of each participant is not required for syndicate action), takes control of the money, property, and business of the enterprise, and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

§ 29.3797-5 *Limited partnerships.* (a) A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law.

(b) The Uniform Limited Partnership Act has been adopted in several States. A limited partnership organized under the provisions of that act may be either an association or a partnership depending upon whether or not in the particular case the essential characteristics of an association exist.

§ 29.3797-6 *Partnership association.* A partnership association of the type authorized by the statutes of several States, such, for instance, as those of the State of Pennsylvania (Purdon's Penna. Stat. Ann., (Perm. Ed.), Title 59, ch. 3), having by virtue of the statutory provisions under which it was organized, the characteristics essential to an association within the meaning of the Internal Revenue Code, is taxable as a corporation.

§ 29.3797-7 *Insurance company.* (a) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(b) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Internal Revenue Code. For example, during the year 1942 the M Corporation, incorporated under the insurance

laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1942 within the meaning of the Code and this part.

§ 29.3797-8 *Domestic, foreign, resident, and nonresident persons.* A domestic corporation is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory, and a foreign corporation is one which is not domestic. A domestic corporation is a resident corporation even though it does no business and owns no property in the United States. A foreign corporation engaged in trade or business within the United States is referred to in this part as a resident foreign corporation, and a foreign corporation not engaged in trade or business within the United States, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States is referred to in this part as a resident partnership, and a partnership not engaged in trade or business within the United States, as a nonresident partnership. Whether a partnership is to be regarded as resident or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized. The term "nonresident alien," as used in this part, includes a nonresident alien individual and a nonresident alien fiduciary.

§ 29.3797-9 *Fiduciary.* "Fiduciary" is a term which applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary for income tax purposes is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.

§ 29.3797-10 *Fiduciary distinguished from agent.* There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal Revenue Code. In cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal.

§ 29.3797-11 *Military or naval forces of the United States.* The term "military or naval forces of the United States" is defined in section 3797 (a) (15). The term includes, among other organizations, the Coast Guard, which in turn includes the Coast Guard Reserve, of which the Women's Reserve is a branch. The definition in section 3797 (a) (15) is inclusive only and not exclusive.

SUBPART G—MITIGATION OF EFFECT OF LIMITATION AND OTHER PROVISIONS IN INCOME TAX CASES

AUTHORITY: §§ 29.3801 (a) (1)-1 to 29.3808-4 issued under 53 Stat. 32, 467; 26 U. S. C. 62, 3791.

SOURCE: §§ 29.3801 (a) (1)-1 to 29.3808-4 contained in Regulations 111, 8 F. R. 15234, except as noted following sections affected.

§ 29.3801 (a) (1)-1 *Purpose and scope of section 3801.* Section 3801 provides for correction of the effect of certain types of errors specified in section 3801 (b) and §§ 29.3801 (b)-1 to 29.3801 (b)-5 when one or more provisions of the internal revenue laws, such as the statute of limitations, would otherwise prevent such correction. Corrections are authorized under section 3801 only when the Commissioner, if the correction would result in an allowance of a refund or credit for the year with respect to which the error was made, or the taxpayer, if the correction would result in an additional assessment for such year, has maintained a position inconsistent with the error. No correction is permissible unless the inconsistent position is adopted by a determination made on or after August 27, 1938.

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§ 29.3801 (a) (1)-2 *Closing agreement as a determination.* For the purposes of section 3801, a determination may take the form of a closing agreement authorized by section 3760. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. If it becomes necessary or desirable to effect a determination in order to obtain or accelerate an adjustment authorized by section 3801, a closing agreement may be used for such purpose whenever a taxpayer and the Government have concurred in the disposition of an item or items. A closing agreement becomes final within the meaning of section 3801 on the date of its approval by the Secretary, the Under Secretary, or an Assistant Secretary.

§ 29.3801 (a) (1)-3 *Decision by The Tax Court or court as a determination.* (a) A determination may take the form of a decision by The Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by The Tax Court becomes final is prescribed in section 1140.

(c) The date upon which a judgment of a court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

§ 29.3801 (a) (1)-4 *Final disposition of claim for refund as a determination.* A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i. e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a disposition in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(a) *Items with respect to which the taxpayer's claim is allowed.* (1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if:

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 3772), is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(b) *Items with respect to which the taxpayer's claim is disallowed.* The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 3772 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period, if:

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part and denied in part. For example, if the taxpayer claims a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained but in the amount of $5,000 only, or that a deductible loss of $10,000 was sustained, under the Commissioner's computation

but under the Commissioner's computation the consequent overpayment is only $2,000, the disposition of the claim for refund with respect to both the allowance of the $5,000 and the disallowance of the remaining $5,000, or the allowance of the $2,000 overpayment and the denial of the $500, becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(c) *Items applied by the Commissioner in reduction of the refund or credit.* If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 3772 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition by the Commissioner of a claim for refund within the meaning of section 3801 (a) (1) (C) (ii), but subsequent action taken with respect to such deficiency may result in a determination under section 3801 (a) (1) (A) or (B).

The necessity of waiting for the expiration of the 2-year period of limitations provided in section 3772 may be avoided in such cases as are described under paragraph (b) or (c) of this section by the use of a closing agreement to effect a determination.

§ 29.3801 (a) (3)-1 *Related taxpayer.* An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 3801 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 3801 (a) (3). The concept of "related taxpayer" has application only to section 3801 (b) (1), (2), (3) or (4) and does not apply to section 3801 (b) (5). If such relationship exists, it is not essential that the error be with respect to a transaction possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 3801 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See § 29.3801 (b)-8 for the requirement in certain cases that the relationship exists at the time an inconsistent position is first maintained.

§ 29.3801 (b)-0 *Circumstances of adjustment.* (a) Section 3801 may be applied to correct the effect of an error if, on the date of the determination, correction of the effect of the error is prevented by the operation, whether before, on, or after May 28, 1938 (the date of enactment of the Revenue Act of 1938), of any provision of the internal revenue laws other than section 3801 and other than section 3761 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to compromises). Examples of such provisions are: Sections 275, 311 (b) and (c), 322 (b) and (d), 1117 (e), 3746, and 3772 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to periods of limitation); sections 272 (f) and 322 (c) of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to effect of petition to The Tax Court of the United States on further deficiency letters and on credits or refunds); section 3760 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to closing agreements); and sections 3770 (a) (2), 3774, and 3775 of the Internal Revenue Code and the corresponding provisions of prior revenue acts (relating to payments, refunds or credits after period of limitation has expired).

(b) If the tax liability for the year with respect to which the error was made has been compromised under section 3761 of the Internal Revenue Code or the

corresponding provisions of prior revenue acts, no adjustment may be made under section 3801 with respect to that year.

(c) Section 3801 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to such section.

(d) The determination may be with respect to the tax imposed by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code, by the corresponding provisions of any prior revenue acts, or by more than one of such provisions. Section 3801 may be applied to correct the effect of the error only as to the tax or taxes for the year with respect to which the error was made which correspond to the tax or taxes to which the determination relates. Thus, if the determination relates to the tax imposed by chapter 1 of the Internal Revenue Code, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of the revenue act applicable to the year with respect to which the error was made; if the determination relates to subchapter B of chapter 2 of the Internal Revenue Code, the adjustment may be only with respect to the tax imposed by such subchapter or by the corresponding provisions of the revenue act applicable to the year with respect to which the error was made.

§ 29.3801 (b)-1 *Double inclusion of item of gross income.* Section 3801 (b) (1) applies if the determination requires the inclusion, in a taxpayer's gross income, of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

Example (1). A taxpayer who keeps his books on the cash basis erroneously included in his return for 1934 an item of accrued rent. In 1939, after the period of limitations on refunds for 1934 has expired, the Commissioner discovers that the taxpayer received his rent in 1935 and asserts a deficiency for the year 1935, which is sustained by The Tax Court of the United States in 1942. An adjustment is authorized with respect to the year 1934. If the taxpayer had returned the rent for both 1934 and 1935 and by a determination was denied a refund claimed for 1935 on account of the rent item, a similar adjustment is authorized.

Example (2). A husband assigned to his wife salary to be earned by him in the year 1940. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1940 with respect to a different item and she contested that deficiency before The Tax Court. The wife would therefore be barred by section 322 (c) from filing a claim for refund for 1940. Thereafter, the Commissioner asserts a deficiency against the husband on account of the omission of such salary from his return for 1940. The husband unsuccessfully contests the deficiency before The Tax Court in 1942. An adjustment is authorized with respect to the wife's tax for 1940.

§ 29.3801 (b)-2 *Double allowance of a deduction or credit.* Section 3801 (b) (2) applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

Example (1). A taxpayer in his return for 1937 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently it was discovered that the forest fire occurred in 1938 rather than in 1937. After the expiration of the period of limitations for the assessment of a deficiency for 1937, the taxpayer files a claim for refund for 1938 based upon a deduction for the fire loss in that year. The Commissioner in 1942 allows the claim for refund. An adjustment is authorized with respect to the year 1937.

Example (2). The beneficiary of a testamentary trust in his return for 1936 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1936 with respect to a different item and final decision of The Tax Court of the United States was rendered in 1938, so that the Commissioner was thereafter barred by section 272 (f) of the Revenue Act of 1936 from asserting a further deficiency against the beneficiary for 1936. The trustee thereafter filed a timely refund claim contending that under the terms of the will the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1942 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1936.

§ 29.3801 (b)-3 *Erroneous exclusion of item of gross income with respect to which tax was paid.* Section 3801 (b) (3) applies if the determination requires the exclusion, from a taxpayer's gross income, of an item with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

Example (1). A taxpayer received payments in 1939 under a contract for the performance of services and included the pay-

ments in his return for that year. A closing agreement was thereafter made with respect to the tax liability of the taxpayer for 1938. The taxpayer subsequently filed claim for refund for the year 1939, asserting that he kept his books on the accrual basis and that, as the payments had accrued in 1938, they were properly taxable in that year. The claim for refund is allowed in 1942. An adjustment is authorized with respect to the year 1938. If the taxpayer had not included the payments in any return and the Commissioner had asserted a deficiency for 1939 with respect to the payments, and the deficiency is not sustained by The Tax Court of the United States in its final decision in 1943, no adjustment is authorized with respect to the year 1938. Although the determination requires the exclusion of the item from gross income, no tax has been paid with respect thereto. If the taxpayer, however, had paid the deficiency and thereafter successfully contested it before The Tax Court or successfully sued for refund in court, an adjustment is authorized.

Example (2). A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1935 and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1935, the father filed a claim for refund of that portion of his 1935 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1942. An adjustment is authorized with respect to the son's tax for 1935.

§ 29.3801 (b)-4 *Correlative deductions and inclusions specified in section 162 (b) and (c) and corresponding provisions of prior revenue acts.* Section 3801 (b) (4) applies if the determination relates to the additional deduction specified in section 162 (b) and (c) of the Internal Revenue Code, or the corresponding provisions of a prior revenue act, for amounts distributable to the beneficiaries, heirs, or legatees of an estate or trust, and such determination requires:

(a) The allowance to the estate or trust of such additional deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees.

(b) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when such additional deduction has been erroneously disallowed to or omitted by the estate or trust;

(c) The disallowance to an estate or trust of such additional deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(d) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when such additional deduction has been erroneously allowed to the estate or trust.

The provisions of paragraph (a) of this section may be illustrated as follows:

Example. For the taxable year 1936, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire net income as taxable to the trust. Accordingly, the beneficiary did not include the trust income in his return for the year 1936. In 1938 a State court held invalid the clause directing accumulation. In 1940 the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1936. The claim is sustained by the court in 1942, after the expiration of the period of limitations upon deficiency assessment against the beneficiary for the year 1936. An adjustment is authorized with respect to the beneficiary's tax for the year 1936.

The provisions of paragraph (b) of this section may be illustrated as follows:

Example. Assume the same facts as in the example under paragraph (a), except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1936. The deficiency is sustained by final decision of The Tax Court of the United States in 1942, after the expiration of the period for filing claim for refund on behalf of the trust for 1936. An adjustment is authorized with respect to the trust for the year 1936.

The provisions of paragraph (c) of this section may be illustrated as follows:

Example. A trustee claimed in the return for 1936 a deduction for income distributed to the beneficiary. The income was included by the beneficiary in his return for 1936. In 1940 the Commissioner asserts a deficiency against the trust on the ground that the amount distributed to the beneficiary represented a charge against the corpus of the trust and did not constitute a distribution of income. The deficiency is sustained by final decision of The Tax Court in 1942, after the expiration of the period for filing claims for refund by the beneficiary for 1936. An adjustment is authorized with respect to the beneficiary's tax for the year 1936.

The provisions of paragraph (d) of this section may be illustrated as follows:

Example. Assume the same facts as in the example under paragraph (c), except that,

instead of the Commissioner's asserting a deficiency, the beneficiary files a refund claim for 1936 on the same ground. The claim is sustained by the court in 1942, after the expiration of the period of limitations upon deficiency assessments against the trust for 1936. An adjustment is authorized with respect to the trust for the year 1936.

§ 29.3801 (b)-5 *Determination of basis of property in case of erroneous treatment of transaction relating to acquisition thereof.* Section 3801 (b) (5) applies if the determination establishes the basis of property for income tax purposes and in respect of the transaction upon which such basis depends there was an erroneous inclusion in or omission from gross income or an erroneous recognition or nonrecognition of gain or loss with respect to the taxpayer with respect to whom the determination is made, or any person who acquired title to such property in such transaction and the taxpayer with respect to whom the determination is made mediately or immediately derived title from such person subsequent to such transaction. Section 3801 (b) (5) applies with respect to the person who acquired the property and any subsequent transferees or donees who have a substituted basis ascertained by reference to the basis in the hands of such person. No adjustment is authorized with respect to the transferor of the property in the transaction upon which the basis of the property depends, when the determination is with respect to the original transferee, or a subsequent transferee of such original transferee.

Example (1). In 1936 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1936 taxpayer A treated the exchange as one in which gain or loss was not recognizable;

(a) In 1942 the X Corporation claims that gain should have been recognized on the exchange in 1936 and therefore the property it received had a $10,000 basis for depreciation. Its contention is confirmed by a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1936, as there was no "erroneous inclusion in or omission from the gross income of, or an erroneous recognition or nonrecognition of gain or loss to" the X Corporation with respect to the exchange in 1936. Moreover no adjustment is authorized with respect to taxpayer A, as he is not the taxpayer with respect to whom the determination is made, nor does the determination relate to the property which taxpayer A acquired in the exchange in 1936, but, rather, to the property which he transferred in such exchange.

(b) In 1942 the X Corporation transfers the property to the Y Corporation in a tax-free exchange. In 1943 the Y Corporation sells the property and computes its profit on the basis of $10,000, which basis is sustained by The Tax Court of the United States. No adjustment is authorized with respect to the Y Corporation or with respect to taxpayer A, for the reason stated in (a).

(c) In 1944 taxpayer A sells the stock which he had received in 1936 and claims that, as gain should have been recognized on the exchange in 1936, the basis for computing the profit on the sale is $10,000. His contention is confirmed in a closing agreement. An adjustment is authorized with respect to his tax for the year 1936, as the basis for computing gain on the sale depends upon the transaction in 1936 and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, "the taxpayer" with respect to whom the determination is made.

(d) Taxpayer A does not sell the stock but makes a gift of it to taxpayer B, who later sells the stock and claims the $10,000 basis, which contention is confirmed in a closing agreement. An adjustment is authorized with respect to the tax of taxpayer A for 1936, as the basis for computing gain on the sale by taxpayer B depends upon the transaction in 1936 and in respect of that transaction there was erroneous nonrecognition of gain to taxpayer A, the "person who acquired title to such property in such transaction and from whom * * * immediately" taxpayer B, with respect to whom the determination is made, "derived title subsequent to such transaction."

Example (2). In 1937 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1937 taxpayer A failed to include the profit on such sale. In 1942 taxpayer B sells the property for $12,000 and in his return for 1942 reports a gain of $2,000 upon the sale, which is confirmed in a closing agreement. No adjustment is authorized with respect to the tax of taxpayer A for 1937, as taxpayer A is not the taxpayer with respect to whom the determination is made; nor does the determination relate to property which taxpayer A acquired in the transaction in 1937, but rather to property which he transferred in such transaction.

Example (3). In 1936 a taxpayer received as additional compensation shares of stock in a corporation but did not include any amount in his return for that year on account of the receipt of such stock. In 1942, after the expiration of the period of limitations on deficiency assessments for 1936, he sells the stock for $15,000 and reports $5,000 in his return for 1942 as profit on the sale. A deficiency is asserted by the Commissioner on the theory that the basis is zero and the recognized gain is $15,000. The Tax Court sustains the taxpayer's contention that the

transaction was erroneously treated in 1936 in that the property then had a fair market valuation of $10,000. An adjustment is authorized with respect to the year 1936.

Example (4). In 1933 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1933 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1934 and in his return for that year treated such shares as having a $6,000 basis. In 1939 the taxpayer sells the remaining 50 shares of stock of the X Corporation for $7,500 and reports $1,500 gain in his return for 1939. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1933 and 1934, the Commissioner asserts a deficiency for 1939 on the ground that the loss realized on the exchange in 1933 was erroneously treated as nonrecognizable, and that the basis for computing gain upon the sale in 1939 is $2,500, resulting in a gain of $5,000. The deficiency is sustained by The Tax Court in 1943. An adjustment is authorized with respect to the year 1933 as to the entire $7,000 loss realized on the exchange. No adjustment is authorized with respect to the year 1934 as the basis for computing gain upon the sale of the 50 shares in 1939 does not depend upon the transaction in 1934.

§ 29.3801 (b)-6 *Law applicable in determination of error.* The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 3801.

§ 29.3801 (b)-7 *Operation dependent upon maintenance of inconsistent position*—(a) *Adjustments resulting in additional assessments.* An adjustment which would result in an additional assessment is authorized only if (1) the taxpayer, with respect to whom the determination is made, has, in connection therewith, maintained a position which is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, and (2) such inconsistent position is adopted in the determination.

Example (1). A taxpayer in his return for 1937 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1938 and after the period of limitations upon the assessment of a deficiency for 1937 had expired, it was discovered that the loss actually occurred in 1938. The taxpayer, therefore, filed a claim for refund for the year 1938 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1942. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1937 by filing a claim for refund for 1938 based upon the same deduction. As the determination—the allowance by the Commissioner of the claim for refund—adopts such inconsistent position, an adjustment is authorized for the year 1937.

An adjustment which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example (2). In example (1) above, assume that the taxpayer did not file a claim for refund for 1938 but the Commissioner issued a notice of deficiency for 1938 based upon other items. The taxpayer filed a petition with The Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance of a deduction for the loss previously allowed for 1937. The Tax Court took the deduction into account in its redetermination in 1942 of the tax for the year 1938. In such case no adjustment would be authorized for the year 1937 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

(b) *Adjustments resulting in refund or credit.* An adjustment which would result in the allowance of a refund or credit is authorized only if (1) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, and (2) such inconsistent position is adopted in the determination.

Example (1). A taxpayer who keeps his books on the cash basis erroneously included in his return for 1936 an item of accrued interest. After the period of limitations on refunds for 1936 had expired, the Commissioner asserted a deficiency for the year 1937 on the ground that the item of interest was received in 1937, and, therefore, was properly includible in gross income for that year. The taxpayer appealed to The Tax Court, which in 1942 sustained the deficiency. By asserting a deficiency for 1937 based upon the inclusion of the interest item in that year, the Commissioner has maintained a position inconsistent with the inclusion of the interest item in 1936. As the determination—the decision of The Tax Court sustaining the deficiency—adopted such inconsistent position, an adjustment is authorized for the year 1936.

An adjustment which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example (2). In example (1) above, assume that the Commissioner asserted a deficiency for 1937 based upon other items for that year, but in computing the net income upon which such deficiency was based did not include the item of interest. The taxpayer appealed to The Tax Court and in his petition asserted that the interest item should be included in gross income for 1937. The Tax Court in 1942 included the item of interest in its redetermination of the tax for the year 1937. In such case, no adjustment would be authorized for 1936 as the taxpayer, and not the Commissioner, has maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

§ 29.3801 (b)-8 *Existence of status of related taxpayer at time of the first maintenance of an inconsistent position.* (a) No adjustment by way of a deficiency assessment shall be made with respect to a related taxpayer unless the relationship existed both in the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained, in the manner described in this section, the inconsistent position with respect to the taxable year to which the determination relates.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to The Tax Court of the United States for the taxable year in respect of which the determination is made, the requisite relationship must exist on the date of filing such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained then the relationship must exist on the date of the determination, as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to The Tax Court, and a determination is effected by means of a closing agreement.

§ 29.3801 (c)-1 *Method of adjustment.* (a) If the amount of the adjustment ascertained pursuant to section 3801 (d) represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year with respect to which the error was made. The amount of the adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by section 3801 (e). Notice of deficiency, unless waived, must be issued with respect to such amount and the taxpayer may contest the deficiency before The Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to section 3801 (d) represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the taxable year with respect to which the error was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by section 3801 (e). The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund. The amount of the adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the error was made.

(b) For the purpose of the adjustment authorized by section 3801, the period of

limitation upon the making of an assessment or upon refund or credit for the taxable year with respect to which the error was made, as the case may be, shall be considered as if, on the date of the determination, one year remained before the expiration of such period, regardless of whether or not such period had expired prior to the date of the determination. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such amount is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies, will suspend the running of the 1-year period of limitations provided by section 3801 (c). In accordance with the applicable law and regulations governing the collection of deficiencies (see section 276 (c) of the Internal Revenue Code and the corresponding provisions of prior revenue acts), the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. Similarly, the taxpayer has a period of one year from the date of the determination within, which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of claim for refund, the period of limitation upon filing claim for refund will commence to run from the date of such payment (see section 322 (b) of the Internal Revenue Code and the corresponding provisions of prior revenue acts).

§ 29.3801 (d)-1 *Ascertainment of amount of adjustment.* (a) In computing the amount of the adjustment under section 3801 there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made they must be taken into account. In such cases, the tax previously determined will be ascertained as follows:

(1) For taxable years beginning before January 1, 1943, the tax previously determined will be the tax shown on the return, increased by any amounts previously assessed (or collected without assessment) as deficiencies, and decreased by any amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. If no amount was shown as the tax upon the return, or if no return was made, the tax previously determined will be the sum of the amounts previously assessed, or collected without assessment, as deficiencies decreased by any amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax.

(2) For taxable years beginning after December 31, 1942, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates shall be determined in accordance with the provisions of section 271 and § 29.271-1 (b).

(b) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code, by the corresponding provisions of prior revenue acts, or by any one or more of such provisions.

(c) After the tax previously determined has been ascertained, a recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(d) With the exception of the items upon which the tax previously determined was based and the item or items with respect to which the error was made, no other item shall be considered in computing the amount of the adjustment. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e. g., charitable contributions,

foreign tax credit, earned income credit), readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(e) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

Example. For the taxable year 1936 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return disclosing gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet paid in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $5,294.12 on account thereof, representing the maximum deduction allowable under the 15 percent limitation imposed by section 23 (o), Revenue Act of 1936. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $3,565, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1936, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1937 and asserted a deficiency for that year. As a result of a final decision of The Tax Court of the United States in 1942 sustaining the deficiency for 1937, an adjustment is authorized for the year 1936. The amount of the adjustment is computed as follows:

Tax previously determined for 1936	$3,565.00
Net income for 1936 upon which tax previously determined was based	30,000.00
Less: Rents erroneously included	5,000.00
Balance	25,000.00
Adjustment for contributions (add 15 percent of $5,000)	750.00
Net income as adjusted	25,750.00
Tax as recomputed	2,646.50
Tax previously determined	3,565.00
Difference	918.50
Amount of adjustment to be refunded or credited	918.50

In accordance with the provisions of section 3801 (d), the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

[Regs. 111, 8 F. R. 15234, as amended by T. D. 5447, 10 F. R. 3080]

§ 29.3801 (e)-1 *Effect of other items on amount of adjustment.* The amount of the adjustment ascertained under section 3801 (d) shall not be diminished by any credit or set-off based upon any item inclusion, deduction, credit, exemption, or gain or loss with respect to the year as to which the error was made.

Example (1). In the example set forth in § 29.3801 (d)-1, if, after the amount of the adjustment has been ascertained, the taxpayer filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1936; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the amount of tax which should have been paid with respect to such interest.

Example (2). Assume that a taxpayer included in his gross income for the year 1943 an item which should have been included in gross income for the year 1942. After expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1942 the taxpayer filed a claim for refund for the year 1943 on the ground that such item was not properly includible in gross income for that year. The claim for refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 3801 with respect to the tax for 1942. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before The Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1942; nor could The Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1942 resulting from the failure to take such deduction.

If the Commissioner has refunded the amount of an adjustment under section 3801, the amount so refunded may not subsequently be recovered by the Commissioner in a suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss (other than the one which was the subject of the error) with respect to the year as to which the error was made.

Example (3). In the example set forth in § 29.3801 (d)-1, if the Commissioner had re-

funded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1936, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

If the Commissioner has assessed and collected the amount of an adjustment, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss (other than the one which was the subject of the error) with respect to the year as to which the error was made.

Example (*4*). In example (2) above, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon his failure to take an allowable deduction for the year 1942.

If the amount of the adjustment is considered as an overpayment, it may be credited, under the applicable law and regulations thereunder, against any income or excess-profits tax, or installment thereof, due from the taxpayer. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of income or excess-profits tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 322 of the Internal Revenue Code and the corresponding provisions of prior revenue acts.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 3801 for the year with respect to which the error was made.

§ 29.3808-1 *Deferment of certain taxes of members of the military or naval forces*—(a) *In general.* (1) Section 3808 provides that, in the case of members of the military or naval forces of the United States, that portion of the tax under chapter 1 which is attributable to service pay for a war year, may, in lieu of the time otherwise prescribed by law, be paid in 12 equal quarter-annual installments beginning with the "first installment date". As to what constitutes the "first installment date" for the purposes of section 3808 see § 29.3808-2.

(2) The term "war year" as defined in section 3808 (a) (2) means, in the case of tax attributable to service pay, any taxable year beginning after December 31, 1939, and before January 1, 1947.

(3) For the purposes of section 3808 the military or naval forces of the United States include (but are not necessarily limited to) the Army, the Navy, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Navy Nurse Corps, Female, the Women's Army Auxiliary Corps or the Women's Army Corps, the Women's Reserve branch of the Naval Reserve, the Marine Corps Women's Reserve, and the Coast Guard Reserve, including the Coast Guard Women's Reserves. Such forces do not include the Army Specialist Corps.

(4) Section 3808 is applicable only to the individual who performs service as a member of the military or naval forces of the United States. Hence, it has no application to the spouse of such individual, unless the spouse also performs such service.

(5) Nothing contained in section 3808 shall be construed to require payment of the tax for any taxable year before the postponed due date of the tax for such year under section 3804, if such section is applicable, nor before the last day of any period of extension allowed under the provisions of section 513 of the Soldiers' and Sailors' Civil Relief Act of 1940.

(b) *Application for deferred payments.* In order to obtain the privilege of deferred payments under section 3808 with respect to tax for a taxable year, the taxpayer must make written application, prior to the first installment date, to the collector of internal revenue for the district in which the return for such taxable year is filed. No particular form is required but the application should contain a complete statement of the facts necessary to determine the taxpayer's eligibility for the benefits of section 3808, the taxable years and the amounts of tax involved, and the due date of the first payment. The essential facts include:

(1) Rank and organization.

(2) Whether the taxpayer is an officer of the regular component of the Army, Navy, Marine Corps or Coast Guard.

(3) Date of induction or entrance into armed forces.

(4) Date of release from active duty, if so released.

(5) If the taxpayer performed service outside the continental United States or on sea duty, the date on which the tax-

payer left the continental United States or commenced to serve on sea duty and the date on which he returned to the continental United States or ceased to serve on sea duty.

(6) If, under the provisions of section 513 of the Soldiers' and Sailors' Civil Relief Act, an extension of time for payment of the tax for a war year has been granted, the date upon which such period of extension expires.

(7) The amount of tax for which deferment is claimed for each taxable year involved.

(c) *Interest.* (1) If deferred payments are authorized under the provisions of section 3808, 1/12 of the tax in respect of which deferment is authorized is payable on the first installment date, 1/12 thereof on the corresponding date of the third month following the first installment date, and 1/12 on the corresponding date of each succeeding third month after the preceding installment date until the full amount of the tax is paid.

(2) No interest shall be charged or paid if the tax is paid upon the prescribed dates. Interest at the rate of 6 percent per annum shall be charged on installments not paid at the time prescribed from the date the installment became due until the installment is paid. If the taxpayer fails to pay an installment of the tax on the prescribed date, such failure shall not accelerate the due date of the remaining installments.

(3) Any interest paid prior to November 8, 1945, on that portion of the tax for any taxable year which could be deferred under the provisions of section 3808 shall be credited or refunded to the taxpayer, if claim therefor is filed prior to January 1, 1947, with the collector of internal revenue as the authorized representative of the Commissioner.

(d) *Suspension of period of limitation.* If deferred payments in respect of the tax for any taxable year are authorized in accordance with the provisions of section 3808, the running of the period of limitations under section 276 (c) on the collection of such tax is suspended for the period beginning with the date of filing of the application under section 3808 (b) and ending six months after the date prescribed for payment of the last installment of such tax.

[T. D. 5508, 11 F. R. 4231]

§ 29.3808-2 *First installment date*—(a) *General rule.* Under the definition contained in section 3808 (a) (4), if neither section 3804 and the regulations thereunder nor section 513 of the Soldiers' and Sailors' Civil Relief Act is applicable, the "first installment date" with respect to tax for a war year is as follows:

(1) *Taxpayers released from active duty prior to December 1, 1945.* In the case of taxpayers released from active duty in the military or naval forces of the United States prior to December 1, 1945, the first installment date with respect to tax for a war year is May 15, 1946, or the 15th day of the third month following the close of such war year, whichever is the later.

(2) *Other taxpayers.* In the case of taxpayers released from active duty in the military or naval forces of the United States on or after December 1, 1945, and in the case of taxpayers who have not been released from such active duty, the first installment date with respect to tax for a war year is (i) June 15, 1947, or (ii) the 15th day of the sixth month which begins after the date of the taxpayer's release from active duty, whichever is the earlier, but in no case shall the first installment date be earlier than the 15th day of the third month following the close of such war year. In the case of taxpayers who make their returns on a calendar year basis the "first installment date", if neither section 3804 and the regulations thereunder nor section 513 of the Soldiers' and Sailors' Civil Relief Act is applicable, is as follows:

CALENDAR YEARS 1940 TO 1945, INCLUSIVE

Released from active duty:	*First installment date*
Before Dec. 1, 1945	May 15, 1946.
On or after Dec. 1, 1945, but not later than Nov. 30, 1946.	15th day of sixth month which begins after date of release.
On or after Dec. 1, 1946	June 15, 1947.

CALENDAR YEAR 1946

Released from active duty:	*First installment date*
Before October 1, 1946	March 15, 1947.
During October 1946	April 15, 1947.
During November 1946	May 15, 1947.
On or after Dec. 1, 1946	June 15, 1947.

(b) *Special provisions.* If, by reason of service on sea duty or outside the continental United States, the due date of the tax for a war year is postponed under the provisions of section 3804 and the regulations thereunder or, if collection of the tax for a war year is deferred under the provisions of section 513 of the

Soldiers' and Sailors' Civil Relief Act, the "first installment date" may be later than the date determined under the general rule set forth in paragraph (a) of this section. In such event the first installment date with respect to tax for such war year shall be whichever of the following is the latest:

(1) The date determined under paragraph (a) of this section, or

(2) The postponed due date of the tax determined under section 3804 and the regulations thereunder, or

(3) The last day of the period of deferment allowed under section 513 of the Soldiers' and Sailors' Civil Relief Act. [T. D. 5508, 11 F. R. 4232]

§ 29.3808-3 *Tax attributable to service pay.* (a) The term "tax attributable to service pay" is used in section 3808 to characterize that portion of the tax imposed under chapter 1 for a war year which results from the inclusion in gross income of the compensation for active service as a member of the military or naval forces of the United States. Under the definition contained in section 3808 (a) (1) the term "tax attributable to service pay" for a war year means:

(1) If the taxpayer had no gross income for such war year other than the compensation for active service in such forces, the tax imposed under chapter 1, or

(2) If the taxpayer had gross income for such war year in addition to the compensation for active service in such forces, the excess of the tax imposed under chapter 1 for such year over the tax that would be imposed were such compensation excluded from the gross income.

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

(c) In computing the amount of the "tax attributable to service pay" for a war year the tax imposed under chapter 1 shall be determined without regard to the credit under section 31 for taxes paid to a foreign country or a possession of the United States and without regard to the credits provided in sections 32 and 35 for taxes withheld at the source.

(d) For the purposes of section 3808, the term "tax attributable to service pay" has no application to commissioned officers of the regular component of the Army, Navy, Marine Corps, or Coast Guard for any war year unless, by reason of service on sea duty or outside the continental United States, the due date of the tax for such year is postponed under the provisions of section 3804 and the regulations thereunder. For example, a commissioned officer of the regular component of the Army was assigned to duty in Great Britain in February 1942 and served continuously in the European theater thereafter until he returned to the United States in July 1945. Assuming that the officer makes his returns on the calendar year basis, the regular due dates of the taxes under chapter 1 for the war years 1942 to 1944, inclusive, fall prior to January 15, 1946, which is the 15th day of the sixth month after the date of his return to the United States. Accordingly, under the provisions of section 3804, the due dates of the taxes for the taxable years 1942 to 1944, inclusive, are postponed and the taxpayer is eligible for the benefits of section 3808 with respect to the taxes for such years. However, inasmuch as the regular due date of the tax for the taxable year 1945 is March 15, 1946, and such date is later than January 15, 1946, there is no postponement of the due date of the tax for such taxable year under the provisions of section 3804 and payment of the tax for 1945 may not be deferred under the provisions of section 3808.

(e) The computation of the "tax attributable to service pay" may be illustrated by the following example:

Example. Captain B, a reserve officer in the United States Navy, is a married man and has no dependents. During the calendar years 1942 and 1943 he received compensation for active service on sea duty. His base pay amounts to $1,500 in 1942 and $4,000 in 1943. In addition to his service pay, he received income in the form of dividends which amounts to $6,000 in each of the calendar years 1942 and 1943. His allowable deductions for each year for income tax purposes amount to $400 and he had no Victory tax deductions. His wife had no income or deductions for either year. His tax liability for the calendar year 1943 and

the amount of such tax attributable to service pay is computed as follows:

1942

Compensation for active service	$1,500
Dividends	6,000
Gross income	7,500
Less: Allowable deductions	400
Net income	7,100
Less: Personal exemption	1,200
Surtax net income	5,900
Less: Earned income credit (not less than $300)	300
Normal tax net income	5,600
Normal tax at 6 percent	336
Surtax on $5,900	960
Total tax	1,296

1943

INCOME TAX

Compensation for active service	$4,000
Less: $1,500 exclusion under section 22 (b) (13)	1,500
Balance of service pay	2,500
Dividends	6,000
Gross income	8,500
Less: Allowable deductions	400
Net income	8,100
Less: Personal exemption	1,200
Surtax net income	6,900
Less: Earned income credit (not less than $300)	300
Normal tax net income	6,600
Normal tax at 6 percent	396
Surtax on $6,900	1,196
Total tax under sections 11 and 12	1,592

VICTORY TAX

Gross income	$8,500
Deductions	None
Victory tax net income	8,500
Less: Victory tax exemption	624
Income subject to Victory tax	7,876
Victory tax at 5 percent on $7,876	393.80
Less: Victory tax credit (40 percent of tax)	157.52
Net Victory Tax	236.28

Tax for 1943 after giving effect to section 6 of the Current Tax Payment Act of 1943

Income tax under sections 11 and 12	$1,592.00	
Net Victory tax	236.28	
Total tax	1,828.28	
Increase in 1943 tax under section 6 (a) of Current Tax Payment Act of 1943:		
Total tax for 1942	$1,296	
Less amount forgiven (3/4 of $1,296)	972	
Unforgiven portion added to 1943 tax		$324.00
Tax liability for 1943		2,152.28

Computation of tax for 1943 after excluding compensation for active service in armed forces

1942

Gross income	$7,500
Less: Service pay included in gross income	1,500
Gross income (exclusive of service pay)	6,000
Less: Allowable deductions	400
Net income	5,600
Less: Personal exemption	1,200
Surtax net income	4,400
Less: Earned income credit (not less than $300)	300
Normal tax net income	4,100
Normal tax at 6 percent	246
Surtax on $4,400	660
Total tax	906

1943

INCOME TAX

Gross income	$8,500
Less: Service pay included in gross income	2,500
Gross income (exclusive of service pay)	6,000
Less: Allowable deductions	400
Net income	5,600
Less: Personal exemption	1,200
Surtax net income	4,400
Less: Earned income credit (not less than $300)	300
Normal tax net income	4,100
Normal tax at 6 percent	246
Surtax on $4,400	660
Total tax under sections 11 and 12	906

VICTORY TAX

Gross income (exclusive of service pay)	$6,000
Less: Deductions	None

Victory tax net income		$6,000
Less: Victory tax exemption		624
Income subject to Victory tax		5,376
Victory tax at 5 percent on $5,376		268.80
Less: Victory tax credit (40 percent of $268.80)		107.52
Victory tax		161.28

Tax for 1943 after excluding service pay and giving effect to section 6 of the Current Tax Payment Act of 1943

Income tax under sections 11 and 12		$906.00
Victory tax		161.28
Total tax		1,067.28
Increase in 1943 tax under section 6 (a) of the Current Tax Payment Act of 1943:		
Tax for 1942	$906.00	
Less: Amount forgiven (3/4 of $906)	679.50	
Unforgiven portion added to 1943 tax		226.50
Tax for 1943 if compensation for active service excluded		1,293.78
Tax liability for 1943		$2,152.28
Tax liability for 1943 if compensation for active service excluded		1,293.78
Tax attributable to service pay under section 3808		858.50

[T. D. 5508, 11 F. R. 4232]

§ 29.3808–4 *Estimated tax for war years.* (a) Section 3808 (d) contains special rules for the application of section 58, relating to declarations of estimated tax, and section 294 (d), relating to penalties in connection with estimated tax, in the case of certain members of the military or naval forces of the United States who are eligible for the benefit of deferred payments under section 3808. Under the rules prescribed, if all or part of the tax under chapter 1 for a war year could be deferred under the provisions of section 3808, the amount of the compensation for active service as a member of the military or naval forces of the United States shall not be taken into account:

(1) In determining the gross income reasonably expected for such year for the purpose of ascertaining whether a declaration of estimated tax is required under the provisions of section 58 (a);

(2) In determining the amount of the estimated tax for such year under the provisions of section 58 (b); and

(3) In determining the amount of the tax for such year for the purposes of section 294 (d), relating to penalties in connection with estimated tax.

(b) If the taxpayer is eligible for the benefits of section 3808 the provisions of section 3808 (d) are applicable even though the taxpayer does not take advantage of the authorized deferment or does not make application therefor.

(c) The provisions of section 3808 (d) and this section have no application to a member of the military or naval forces who at the time prescribed for making the declaration of estimated tax for a taxable year is a commissioned officer (or a commissioned warrant officer) of the regular component of the Army, Navy, Marine Corps, or Coast Guard. [T. D. 5508, 11 F. R. 4233]

SUBPART H—MISCELLANEOUS PROVISIONS

§ 29.6000 *Extension of time for making certain elections.* If in this part a time is fixed on or before which an election or an application for relief may be made by the taxpayer and such time is not expressly provided in the law, the Commissioner in his discretion may, for good cause shown, except as provided in the next paragraph, grant a reasonable extension of time for the making of such election or application if request for such extension is filed with the Commissioner prior to the time fixed for making such election or application or within such time thereafter as the Commissioner may consider reasonable under the circumstances and it is shown to the satisfaction of the Commissioner that the granting of the extension will not jeopardize the interests of the Government.

The time fixed in this part will not be extended by the Commissioner in such cases as the following: (a) An election required to be made in or with the taxpayer's original income tax return; (b) an election required to be exercised by the filing of a claim for credit or refund unless such election is required to be exercised at a time fixed by this part, which time is before the date of the expiration of the period of limitations provided in section 322, or an election required to be filed in a petition to The Tax Court; (c) an application for permission to change a previous election; or (d) an application for permission to change an accounting method as described in §§ 29.41–2 and 29.123–1, an application for permission to change

an accounting period as described in § 29.46-1, or an application for permission to change the method of treating bad debts as described in § 29.23 (k)-1. (53 Stat. 32, 467; 26 U. S. C. 62, 3791) [T. D. 5391, 9 F. R. 8009, as amended by T. D. 5400, 9 F. R. 10297. Redesignation noted at 14 F. R. 5199]

Part 32—Establishment of Construction Reserve Funds

Sec.
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AUTHORITY: §§ 32.1 to 32.27 issued under 53 Stat. 467; 26 U. S. C. 3791. Interpret or apply sec. 511, 54 Stat. 1106, as amended; 46 U. S. C. and Sup., 1161.

SOURCE: §§ 32.1 to 32.27 contained in Treasury Decision 5330, 9 F. R. 1088, except as noted following sections affected.

NOTE: Regulations for the establishment of construction reserve funds are also codified as Part 287 of Title 46.

§ 32.1 *Definitions.* As used in the regulations in this part, except as otherwise indicated by the context:

(a) The term "act" means the Merchant Marine Act, 1936, as amended;

(b) The term "statute" means section 511 of the Merchant Marine Act, 1936, as amended;

(c) The term "section" means one of the sections of the regulations in this part;

(d) The terms "Commission" and "Maritime Commission" mean the United States Maritime Commission;

(e) The term "citizen" means a person who, if an individual, was born or naturalized as a citizen of the United States or, if other than an individual, meets the requirements of section 905 (c) of the act and section 2 of the Shipping Act, 1916, as amended;

(f) The term "taxpayer" means a citizen who has established or seeks to establish a construction reserve fund under the provisions of the statute and this part, and may include a partnership;

(g) The term "corporation" includes associations and joint stock companies;

(h) The term "stock" includes the share in an association or joint-stock company.

(i) The terms "contract", "contract for the construction", and "construction contract", shall include, in the case of a taxpayer who constructs a new vessel in a shipyard owned by such taxpayer, an agreement between such taxpayer and the Commission with respect to such construction and containing provisions deemed necessary or advisable by the Commission to carry out the purposes and policy of the statute.

Insofar as the computation and collection of taxes are concerned, other terms used in this part, except as otherwise indicated by the context, have the same meaning as in the Internal Revenue Code and the regulations thereunder.

[T. D. 5330, 9 F. R. 1088, as amended by T. D. 5445, 10 F. R. 2608]

§ 32.2 *Scope of statute.* (a) The statute provides, under conditions specified, for the nonrecognition for income and excess-profits tax purposes of the gain realized from the sale or indemnification for loss of certain vessels including certain vessels in course of construction, or shares therein. It also permits the accumulation of the proceeds of such sales or indemnifications and of certain earnings without liability under section 102 of the Internal Revenue Code. (For the normal application of section 102, see §§ 29.102-1 to 29.102-4 of this chapter, and the corresponding provisions of prior regulations.)

(b) The benefits of the statute are available to any citizen as defined in § 32.1 (e), who, during any taxable year beginning after December 31, 1939, owns, in whole or in part, a vessel or vessels

within the scope of § 32.3. A citizen operating such a vessel or vessels owned by any other person or persons can derive no benefit from the provisions relating to the nonrecognition of gain from the sale or loss of such vessel or vessels so owned, but may establish a construction reserve fund in which he may deposit earnings from the operation of such vessel or vessels.

(c) The statute applies only with respect to sales or losses of vessels within the scope of § 32.3 occurring within a taxable year beginning after December 31, 1939, or in respect of earnings derived from the operation of such vessels during a taxable year beginning after December 31, 1939. A loss to be within the statute must be an actual or constructive total loss. Whether there is a total loss, actual or constructive, will be determined by the Maritime Commission. As to what proceeds, earnings, or receipts may be deposited in the construction reserve fund, see §§ 32.13 and 32.14. The loss of a vessel which occurs during a taxable year beginning prior to December 31, 1939, is not within the scope of the statute, even though the taxpayer is indemnified during a later year.

§ 32.3 *Requirements as to operation.* The statute applies with respect to vessels operated in the foreign or domestic commerce of the United States or in the fisheries, and vessels acquired or being constructed for the purpose of such operation. The foreign commerce of the United States includes commerce or trade between the United States (including the District of Columbia), the Territories and possessions which are embraced within the coastwise laws, and a foreign country or other Territories and possessions of the United States. The domestic commerce of the United States includes commerce or trade between ports of the United States and its Territories and possessions, embraced within the coastwise laws. The fisheries include the fisheries of continental United States and its Territories and possessions, except the Philippine Islands (see section 5, 39 Stat. 547; 48 U. S. C. 1003). The statute does not apply to vessels operated in the foreign commerce or fisheries of any country other than the United States.

§ 32.4 *Application to establish fund.* Any person claiming to be entitled to the benefits of the statute may make application, in writing, to the Commission for permission to establish a construction reserve fund. The application shall be in such form and substance as the Commission may prescribe and shall designate, among other things, the depository or depositories with which the applicant proposes to establish the said fund. The original application shall be executed and verified by the taxpayer, or if the taxpayer is a corporation, by one of its principal officers, in triplicate, and shall be accompanied by eight (8) conformed copies when filed with the Commission.

§ 32.5 *Tentative authorization to establish fund.* Where the time between the receipt by the Commission of the application for permission to establish a construction reserve fund and the date prior to which an amount received from the sale or loss of a vessel must be deposited to come within the scope of the statute is insufficient to permit a determination of the eligibility of the applicant, the Commission may tentatively authorize the establishment of a construction reserve fund and the deposit of such amount therein. Such tentative authorization shall be subject to rescission by the Commission, if subsequently it is determined that the applicant is not entitled to the benefit of the statute, and, upon such determination, the fund shall be closed and all amounts on deposit therein shall be withdrawn.

§ 32.6 *Establishment of fund.* (a) If the application is approved by the Commission, the Commission will adopt a resolution authorizing the establishment of a construction reserve fund with the depository or depositories designated by the taxpayer and approved by the Commission. The resolution will provide for joint control by the Commission and the taxpayer over such fund, will set forth the conditions governing the establishment and maintenance of the fund and the making of deposits therein and withdrawals therefrom, and will designate the representatives authorized to execute instruments of withdrawal on behalf of the Commission.

(b) A certified copy of the resolution of the Commission will be furnished the taxpayer. If the taxpayer is a corporation, it shall promptly adopt, through its board of directors, a resolution satisfactory in form and substance to the Commission, authorizing the establishment and maintenance of the fund in

conformity with the action of the Commission. If the taxpayer is not a corporation it shall promptly execute an agreement with the depository satisfactory in form and substance to the Commission to conform to the action of the Commission as set forth in the resolution. Certified copies of the resolutions of the Commission and of the taxpayer (if it is a corporation) will be furnished to the depository by the Commission and the taxpayer respectively for its guidance in maintaining the fund and honoring instruments of withdrawal. The taxpayer, if a corporation, shall also furnish the Commission with a certified copy of its resolution, or if not a corporation, a duplicate original of its agreement with the depository.

§ 32.7 *When reimbursement out of a construction reserve fund permitted.* If, prior to the establishment of a construction reserve fund under the regulations in this part, a taxpayer has made necessary payments under a contract, which satisfies the provisions of the regulations in this part and the statute, for the construction or acquisition of a new vessel, such taxpayer may, if subsequently authorized to establish a construction reserve fund under these regulations, draw against such fund as reimbursement for the amount, if any, of other funds which, with the approval or ratification of the Commission, the taxpayer used prior to the establishment of the fund for the purpose of making such necessary payments.

§ 32.8 *Investment of funds in securities.* Interest-bearing direct obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States, may be deposited in the construction reserve fund in lieu of cash, and such obligations may also be purchased with cash on deposit in the fund. In instances where the taxpayer desires to deposit any other securities in the fund in lieu of cash, or to purchase such other securities with cash on deposit in the fund, the taxpayer shall make written application to the Commission and shall not consummate the transaction until the written consent of the Commission shall have been received. The application shall describe the securities fully. Every approval of such application by the Commission shall be conditioned upon agreement by the taxpayer forthwith to dispose of such securities upon subsequent request by the Commission. Immediately upon the purchase of any securities for deposit in the fund, the taxpayer shall advise the Commission, giving the date of purchase, a description of the securities, and the price paid therefor (net, brokerage and other charges, and gross). Ordinarily, the Commission will not approve the deposit in the fund in lieu of cash, or the purchase with cash on deposit in the fund, of securities not actively traded in on exchanges registered under the "Securities Exchange Act of 1934", or securities which are not legal for investment of trust funds.

§ 32.9 *Valuation of securities in fund.* (a) In cases where securities are deposited in the fund in lieu of cash, or are purchased with cash on deposit in the fund, the "market value" of such securities must not be less than the amount of cash in lieu of which they are so deposited or with which they are so purchased. For the purpose of determining the amount in the fund, the "market value" of securities shall be determined in the following manner:

(1) In instances where no actual purchase is involved, such as the initial deposit of securities in the fund in lieu of cash, the last sales price thereof on the principal exchange on the day the deposit was made shall be deemed to be the "market value" thereof, or, if no such sales were made, the "market value" thereof will be determined by the Commission on such basis as it may deem to be fair and reasonable in each case.

(2) With respect to transactions involving the purchase of securities with cash on deposit in the fund, "market value" shall be the gross price paid (adjusted for accrued interest): *Provided,* That if such securities are purchased otherwise than upon a registered exchange the price shall be within the range of transactions on the exchange on the date of such purchase, or, if there were no such transactions, then the "market value" thereof will be determined by the Commission on such basis as it may deem to be fair and reasonable in each case.

(b) If the securities on deposit in the fund are replaced by cash from the general funds of the taxpayer, the amount of cash to be deposited in the fund in lieu thereof shall be not less than the amount at which such securities were

valued at the time of their deposit in the fund.

(c) Purchase money obligations secured by vessels sold or irrevocable commitments to finance the construction or acquisition of new vessels which are deposited in the construction reserve fund as provided in § 32.13 ordinarily will be considered as equivalent to their face value.

§ 32.10 *Withdrawals from fund.* (a) Checks, drafts, or other instruments of withdrawal to meet obligations under a contract for the construction or acquisition of a new vessel or vessels, after having been executed by the taxpayer, shall be forwarded to the Commission at Washington with appropriate explanation of the purpose of the proposed withdrawal, including properly certified invoices or other supporting papers. Such instruments of withdrawal, if payable to the Commission, will be deposited by the Commission for collection, and the proceeds thereof, upon collection, will be credited to the appropriate contract with the Commission; but if drawn to the order of payees other than the Commission, after countersignature on behalf of the Commission, will ordinarily be forwarded to the payees.

(b) An amount obligated under a contract for the construction or acquisition of a new vessel or vessels, whether the obligor has the entire or a partial interest therein within the scope of the statute, may not, so long as the contract continues in full force and effect, be withdrawn except to meet payments due or to become due under such contract.

(c) Checks, drafts, or other instruments of withdrawal executed by the taxpayer for purposes other than to meet obligations under a contract for the construction or acquisition of a new vessel or vessels, whether the taxpayer has the entire or a partial interest therein, shall be drawn by the taxpayer to its own order and forwarded to the Commission at Washington, with appropriate explanation of the purpose of the proposed withdrawal. Such withdrawals may occur by reason of a determination by the Commission that the applicant is not entitled to the benefits of the statute (see § 32.5), or that a particular deposit has been improperly made (see § 32.13), or by reason of the election of the taxpayer to make such withdrawals. Upon receipt of such checks, drafts, or other instruments of withdrawal, the Commission shall give notice thereof to the Commissioner of Internal Revenue. The Commissioner shall advise the Commission of the receipt of the notice and the date it was received. The Commission shall not countersign such checks, drafts, or other instruments of withdrawal or transmit them to the taxpayer until the expiration of 30 days from the date of receipt of the notice by the Commissioner, unless the Commissioner or such official of the Bureau of Internal Revenue as he may designate for the purpose consents in writing to earlier countersignature by the Commission and transmittal to the taxpayer.

(d) Upon the expiration of such 30-day period, or prior thereto if the aforesaid consent of the Commissioner has been obtained, the Commission will countersign the check, draft, or other instrument of withdrawal and forward it to the taxpayer.

(e) The provisions of this section shall not be applicable to transactions deemed to be withdrawals by reason of the sale of securities held in the fund, for an amount less than the market value thereof at the time of their deposit (see § 32.21), nor to the cancellation of an irrevocable commitment deposited in the fund, upon proof satisfactory to the Commission that the terms of such commitment have been fully satisfied.

§ 32.11 *Time deposits.* (a) Deposits in the construction reserve fund not invested in securities may be placed in time deposits when, in the judgment of the taxpayer, it is desirable and feasible so to do.

(b) The taxpayer shall promptly advise the Commission of any time deposit arrangements made with the depository. The Commision reserves the right at any time to require the termination or modification of any such arrangements.

§ 32.12 *Election*—(a) *General.* (1) As a prerequisite to nonrecognition of gain on the sale or loss of a vessel, or a part interest therein as provided by the statute, the taxpayer, after establishing a construction reserve fund, must make an election with respect to such vessel or share therein.

(2) Deposit of an amount equal to the net proceeds of the sale or loss of the vessel or of the taxpayer's interest therein must be made within the period specified in § 32.15 and may not be delayed beyond

the specified period to await the execution or filing of a statement of election.

(b) *Manner of election*—(1) *General.* Except in cases of certain Government payments covered by subparagraph (2) of this paragraph an election shall be made in accordance with this subparagraph: The election shall be made in the taxpayer's income tax return, or in case of a partnership in the parnership return of income, for the taxable year in which the gain is realized. The election shall be shown by a statement to that effect, submitted as a part of, and attached to, the return. The statement, which need not be on any prescribed form, shall set forth a computation of the amount of the realized gain, the identity of the vessel, the nature and extent of the taxpayer's interest therein, whether such vessel was sold or lost and the date of sale or loss, the full sale price or full amount of indemnity, and the amount and date of each payment thereof, the basis for tax purposes and any other data affecting the determination of the realized gain.

(2) *Certain Government payments.* In case a vessel is purchased or requisitioned by the United States, or is lost, in any taxable year beginning after December 31, 1939, and prior to January 1, 1944, and the taxpayer receives payment for the vessel so purchased or requlsitioned, or receives from the United States indemnity on account of such loss, subsequent to the end of such taxable year, the taxpayer may make his election by filing notice thereof with the Commissioner of Internal Revenue, Washington 25, D. C., prior to March 31, 1945, or prior to the expiration of sixty days after receipt of the payment or indemnity, whichever is later. The taxpayer should file a copy of the notice with the Secretary, United States Maritime Commission, Washington 25, D. C. The form of the notice of election, which form shall be prepared by the taxpayer, shall be substantially as follows:

ELECTION RELATIVE TO NONRECOGNITION OF GAIN UNDER SECTION 511 (c) (2), MERCHANT MARINE ACT, 1936

Pursuant to the provisions of section 511 of the Merchant Marine Act, 1936, as amended by the Act approved December 23, 1944, Public Law 552, Seventy-eighth Congress, notice is hereby given that the undersigned taxpayer elects that gain in respect of the sale to the United States, or identification received from the United States on account of the loss, of the vessel named below or share therein shall not be recognized. The circumstances involved in the computation of such gain are as follows:

Name and other identification of vessel ______

Nature and extent of the taxpayer's interest in the vessel______

Nature of disposition, i. e., sale or loss ______

Date of disposition ______

Full sale price or full amount of indemnity received by taxpayer ______

Amount and date of each payment of sale price or indemnity received by taxpayer ______

Amount and date of each previous deposit of such payments in construction reserve fund ______

Identification of each check or other instrument by which payment made to taxpayer______

Tax basis of taxpayer's interest in vessel______

Any other data affecting the determination of the realized gain______

______

Amount of gain (submit computation) ______

______
(Name of taxpayer)

By ______
(Authorized representative)

______
(Date of execution)

[T. D. 5445, 10 F. R. 2608]

§ 32.13 *Deposit of proceeds of sales or indemnities.* (a) The deposit required by the statute must be made in a construction reserve fund, established with a depository or depositories approved by the Commission and subject to the joint control of the Commission and the taxpayer. It is not necessary to establish a separate fund with respect to each vessel or share in a vessel sold or lost. However, with respect to any vessel sold or lost, or a share therein, the deposit must be in an amount equal to the "net proceeds" of the sale, or the "net indemnity" for the loss. By "net proceeds" and "net indemnity" is meant (1) the depositor's interest in the adjusted basis of the vessel plus (2) the amount of gain which would be recognized for tax purposes in the absence of the statute. In determining "net proceeds" the amount necessarily paid or incurred for brokers' commissions is to be deducted from the gross amount of the sales price. In determining "net indemnity", the amount necessarily paid or incurred purely for collection, or rate of exchange discounts on the payment, of the indemnity is to be deducted from the gross amount of collectible indemnity. Where the pro-

ceeds from the sale of a vessel include purchase money obligations, such obligations together with the entire collateral therefor, or in case of deposit of the proceeds of a share in the vessel a proportionate part of the obligations and collateral as determined by the Commission, shall be deposited, with the remainder of the proceeds, in the construction reserve fund as a part of the "net proceeds". The depository shall receive payment of all amounts due on such purchase money obligations and such amounts shall be placed in the fund in substitution for the portion of the obligations paid. If the taxpayer so desires, he may deposit in the construction reserve fund cash or approved securities in an amount equal to the face value of any purchase money obligations in lieu of depositing such obligations.

(b) The taxpayer must deposit the full amount of each payment (including cash, notes, or other evidences of indebtedness) as a single deposit in the construction reserve fund. A payment divided between two or more depositories will be regarded as a single deposit. Amounts received by the taxpayer prior to the date of consummation of the sale of the vessel shall be considered as having been received by the taxpayer at the time the sale is consummated.

(c) Where a vessel is subject to a mortgage or other encumbrance at the time of its sale or loss and the taxpayer actually receives only an amount representing the equity therein or a share in such equity corresponding to his share in the vessel, he shall deposit in the construction reserve fund the amount received and concurrently therewith other funds in an amount equal to the difference between the amount received and the "net proceeds" or "net indemnity". Such other funds may be in the form of cash, or, subject to the approval of the Commission, (1) interest-bearing securities, or (2) an irrevocable commitment to finance the construction or acquisition of a new vessel in whole or in part by an obligor approved by the Commission in an amount equal to the amount by which the "net proceeds" exceeds the cash or securities deposited in the fund.

(d) In case of the sale or loss of several vessels or shares therein, a deposit of the "net proceeds" or "net indemnity" with respect to one or more of the vessels or shares is permissible. Where several vessels or shares are sold for a lump sum, the "net proceeds" allocated to each vessel or share shall be determined in accordance with any reasonable rule satisfactory to the Commissioner of Internal Revenue.

(e) A deposit which is not provided for by the statute shall, without unreasonable delay, be withdrawn from the fund and tax liability will be determined as though such deposit had not been made. (See §§ 32.10 and 32.22.)

§ 32.14 *Deposit of earnings and receipts.* (a) A citizen may deposit all or any part of earnings derived from operation, within the scope of § 32.3, of a vessel or vessels owned either by himself or any other person. Such earnings may include payments received by an owner, as compensation for use of his vessel, from other persons by whom it is so operated. Earnings from other sources may not be deposited. Only earnings intended for construction or acquisition of new vessels may be deposited. The earnings deposited must be of taxable years beginning after December 31, 1939.

(b) The earnings from operation of vessels which are eligible for deposit are the net earnings determined without regard to any deduction for depreciation, obsolescence, or amortization with respect to such vessels. Receipts from deposited funds, in the form of interest or otherwise, may be deposited.

§ 32.15 *Time for making deposits.* (a) Deposits of amounts representing proceeds of the sale or indemnification for loss of a vessel or share therein must be made within 60 days after receipt by the taxpayer, except that (1) amounts received on or before December 9, 1940, may be deposited not later than February 7, 1941, and (2) amounts, received at any time between May 27, 1941, and June 17, 1943, the deposit of which is authorized by the amendments to subsection (b) of section 511 of the act, made by Public Law 78, approved June 17, 1943, may be deposited not later than October 15, 1943, and the Commission may approve any such deposit previously made between May 27, 1941, and June 17, 1943, if in other respects it complies with the provisions of the statute and the regulations in this part.

(b) Earnings and receipts, within the scope of the statute, of taxable years beginning after December 31, 1939, may be deposited at any time. (See § 32.14.)

§ 32.16 *Tax liability as to earnings deposited.* Deposit in the construction reserve fund of earnings from operation of a vessel or vessels, or receipts, in the form of interest or otherwise, with respect to amounts previously deposited does not exempt the taxpayer from tax liability with respect thereto. Earnings and receipts deposited in a construction reserve fund established in accordance with the provisions of the statute and the regulations in this part do not constitute an accumulation of earnings or profits within the meaning of section 102 of the Internal Revenue Code as long as the requirements of the statute and the regulations in this part relative to the use of the fund in the construction or acquisition of new vessels are satisfied. For application of the statute in case earnings or receipts so deposited are later withdrawn for purposes other than the construction or acquisition of new vessels, or there is failure otherwise to comply with the statute or the regulations in this part, see § 32.21.

§ 32.17 *Allocation of gain for tax purposes.* (a) If the "net proceeds" of a sale or the "net indemnity" in respect of a loss are deposited in more than one deposit, the gain will be considered as first deposited. Amounts expended, obligated, or withdrawn will be applied against the amounts deposited in the order of deposit. If any deposit consists in part of gain not recognized under the statute, any expenditure, obligation, or withdrawal applied against such deposit will be considered to consist of gain in the proportion that the part of the deposit consisting of gain bears to the total amount of the deposit. If amounts on deposit in a construction reserve fund are expended, obligated, or withdrawn for construction or acquisition of new vessels, the portion thereof which represents gain will be applied in reduction of the basis of such new vessels for determining gain or loss, and for depreciation, for the purpose of Federal income or excess-profits taxes. If any amounts are withdrawn for purposes other than the construction or acquisition of new vessels, the portion thereof which represents gain, if otherwise constituting taxable income under the law applicable to the taxable year in which such gain was realized, will be included in the gross income for such taxable year, except for the purpose of the declared value excess-profits tax and the capital stock tax. (See § 32.22.)

(b) The date funds are obligated under a contract for the construction or acquisition of a new vessel, rather than the date of payment from the fund, will determine the order of application against the deposits in the fund. When a contract for the construction or acquisition of a new vessel is entered into, amounts on deposit in the construction reserve fund will be deemed to be obligated to the extent of the amount of the taxpayer's liability under the contract. Deposits will be deemed to be so obligated in the order of deposit, each new contract obligating the earliest deposit not previously expended, obligated, or withdrawn. If the liability under the contract exceeds the amount in the construction reserve fund, the contract will be deemed to obligate, to the extent of that part of such excess not otherwise satisfied, the earliest deposit or deposits thereafter made.

Example. A taxpayer who makes his returns on the calendar year basis sells a vessel in 1941 for $1,000,000, realizing a gain of $400,000. $100,000 of the sale price is received in March 1941 when the contract is signed, and the balance of $900,000 is received in June 1941 on delivery of the vessel. The $1,000,000 is deposited in a construction reserve fund in July 1941. In December 1941 the taxpayer also deposits $150,000, representing earnings of that year. In 1942 he sells another vessel for $1,000,000, realizing a gain of $250,000. The sale price of $1,000,000 is received on delivery of the vessel in February 1942 and deposited in the construction reserve fund in March 1942. In September 1942 the taxpayer purchases for cash out of the construction reserve fund a new vessel for $1,750,000. To the cost of this vessel must be allocated the 1941 deposits of $1,150,000 and $600,000 of the March 1942 deposit. This leaves in the fund $400,000 of the March 1942 deposit. The amount of the unrecognized gain to be applied against the basis of the new vessel is as follows: $400,000 gain represented in the 1941 deposits, plus the same proportion of the $250,000 gain represented in the March 1942 deposit ($1,000,000) which the amount ($600,000) allocated to the vessel is of the amount of the deposit, i. e., $400,000 plus $\frac{600,000}{1,000,000}$ of $250,000, or $150,000, a total of $550,000. This reduces the basis of the new vessel to $1,200,000 ($1,750,000 less $550,000).

In 1943 the taxpayer sells a third vessel for $3,000,000, realizing a gain of $900,000. The $3,000,000 is received and deposited in the construction reserve fund in June 1943, making a total in the fund $3,400,000. In December 1943 the taxpayer contracts for the con-

struction of a second new vessel to cost a maximum of $3,200,000, thereby obligating that amount of the fund, and in June 1944 receives permission to withdraw the unobligated balance amounting to $200,000. To the cost of the second new vessel must be allocated the $400,000 balance of the March 1942 deposit and $2,800,000 of the June 1943 deposit. The unrecognized gain to be applied against the basis of such new vessel is that proportion of the gain represented in each deposit which the portion of the deposit allocated to the vessel bears to the amount of such deposit, i. e., $\frac{400,000}{1,000,000}$ of $250,000, or $100,000 plus $\frac{2,800,000}{3,000,000}$ of $900,000, or $840,000, making a total of $940,000. The $200,000 withdrawn is applied against the June 1943 deposit and the portion thereof which represents gain will be recognized as income for 1943, the year in which realized. The computation of the recognized gain is as follows: $\frac{200,000}{3,000,000}$ of $900,000, or $60,000.

§ 32.18 *Requirements as to new vessels.* (a) For the purposes of the statute and the regulations in this part, the new vessel must be:

(1) Documented under the laws of the United States when it is acquired by the taxpayer, or the taxpayer must agree that when acquired it will be documented under the laws of the United States;

(2) (i) Constructed in the United States after December 31, 1939, or (ii) its construction must have been financed under Title V or Title VII of the act, or (iii) its construction must have been aided by a mortgage insured under Title XI of the act; and

(3) Either (i) of such type, size, and speed as the Maritime Commission determines to be suitable for use on the high seas or Great Lakes in carrying out the purposes of the act, but of not less than 2,000 gross tons or of less speed than 12 knots, except that a particular vessel may be of lesser tonnage or speed if the Maritime Commission determines and certifies that the partciular vessel is desirable for use by the United States in case of war or national emergency, or (ii) constructed to replace a vessel or vessels requisitioned or purchased by the United States, in which event it must be of such type, size, and speed as to constitute a suitable replacement for the vessel requisitioned or purchased, but if a vessel already built is acquired to replace a vessel or vessels requisitioned or purchased by the United States, such vessel must meet the requirements set forth in subdivision (i) of this subparagraph.

(b) A vessel will be deemed to be constructed after December 31, 1939, only if construction was commenced after that date. Subject to the provisions of this section, a new vessel may be built by or for the taxpayer, or may be acquired after it is built.

(c) It is not necessary that vessels shall be replaced vessel for vessel. The new vessels may be more or less in number than the replaced vessels, provided the other requirements of this section are met.

[T. D. 5330, 9 F. R. 1088, as amended by T. D. 5445, 10 F. R. 2608]

§ 32.19 *Contracts obligating deposits.* (a) A contract for the construction or acquisition of a new vessel entered into prior to October 10, 1940, or a contract which supersedes, amends, or supplements such a contract, is not within the scope of the statute. Unless otherwise authorized by the Commission, contracts for the construction of new vessels must be for a fixed price, or provide for a base price that may be adjusted for changes in labor and material costs up to but not exceeding 15 percent of the base price. Plans and specifications for the new vessel or vessels must be approved by the Commission to the extent it deems necessary. A deposit in a construction reserve fund may be expanded or obligated for expenditure for procurement under an acquisition or construction contract of a part interest in a new vessel or vessels, but only after obtaining the written consent of the Commission. The granting of such consent shall be entirely in the discretion of the Commission and it may impose such conditions with respect thereto as it may deem necessary or advisable for the purpose of carrying out the provisions of the statute. Applications for such consent shall be executed in triplicate, and, together with eight conformed copies thereof, filed with the Commission.

(b) Within two years from the date of any deposit in a construction reserve fund, unless extension is granted as provided in this section, such deposit must be obligated under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Commission for a share therein), and at least 12½ percent of the construction or contract price of the entire vessel or vessels

must be actually paid or irrevocably committed on account thereof. Amounts on deposit in a construction reserve fund will be deemed to be obligated for expenditure when a binding construction or purchase contract has been entered into and will be deemed to be irrevocably committed when due and payable in accordance with the terms of the contract of construction or acquisition. The Commission may, upon application and a showing of proper circumstances, allow an extension or extensions of time within which the contract shall be entered into and the deposits expended or obligated, or the 12½ percent of the construction or contract price paid or irrevocably committed, not to exceed two years in the aggregate, except that until the termination of the present war or until such earlier date as the Congress by concurrent resolution or the President may designate, further extensions may be granted by the Commission. Such further extensions may not run longer than six months after such termination or earlier date.

(c) A taxpayer seeking an extension shall make application therefor, and transmit it with an appropriate statement of the circumstances, and appropriate documents in substantiation of the statement, to the Maritime Commission. The Commission will notify the Commissioner of Internal Revenue of any extension granted. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.

§ 32.20 *Period for construction.* (a) A new vessel constructed otherwise than under the provisions of Title V of the act, and not purchased from the Maritime Commission, must, within six months from the date of the construction contract, or within the period of any extension, be completed to the extent of not less than 5 percent as estimated by the Maritime Commission and certified by it to the Secretary of the Treasury. In case of a contract covering more than one vessel it will be sufficient if one of the vessels is 5 percent completed within the six months' period from the date of the contract or within the period of any extension, and so certified. All construction must be completed with reasonable dispatch as determined by the Maritime Commission. If, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, the Commission will so certify to the Secretary of the Treasury. For the effect of such certification, see § 32.21.

(b) The Maritime Commission may, upon application and a showing of satisfactory reasons therefor, grant an extension or extensions of time within which the 5 percent of construction shall be completed, but such extensions shall not aggregate more than one year, except that until the termination of the present war or until such earlier date as the Congress by concurrent resolution or the President may designate, further extensions may be granted by the Commission. Such further extensions may not run longer than six months after such termination or earlier date. Application for extension shall be made in accordance with the procedure indicated by § 32.19. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.

§ 32.21 *Noncompliance with requirements.* (a) Withdrawal from the construction reserve fund for purposes other than the construction or acquisition of new vessels, or failure to comply with the requirements of the statute or the regulations relative to the utilization of such funds in the construction or acquisition of new vessels, will result in the recognition, for the taxable year in which realized, of the amount of the gain represented in that portion of the fund involved. If securities on deposit in a construction reserve fund are sold and the amount placed in the fund in lieu thereof is less than the market value of the securities at the time of their deposit, the difference between such market value and the amount placed in the fund in lieu of the securities will be deemed to have been withdrawn.

(b) In the event of noncompliance with the prescribed conditions relative to any contract for construction or acquisition of new vessels, recognition will extend to the entire amount of the gain represented in that portion of the construction reserve fund obligated under such contract. Thus, if the Maritime Commission determines and certifies to the Secretary of the Treasury that for causes within the control of the taxpayer construction under a contract is not completed with reasonable dispatch, the entire amount of the gain repre-

sented in the portion of the construction reserve fund obligated under the contract will be recognized even though all other conditions have been satisfied. In case of noncompliance with the requirements of the statute or the regulations in this part, see § 32.17 as to the allocation of gain.

(c) Noncompliance with the provisions of the statute or the regulations in this part relative to the utilization of the deposited amounts may also, inasmuch as the statutory presumption of subsection (f) is then inapplicable, warrant an examination to ascertain whether such amounts constitute an unreasonable accumulation of earnings and profits within the meaning of section 102 of the Internal Revenue Code. Under that section and the regulations thereunder, if such amounts are deposited and the fund maintained in good faith for the purpose of the construction or acquisition of new vessels, such amounts will not constitute an unreasonable accumulation.

§ 32.22 *Extent of tax liability.* (a) Inclusion of gain in gross income shall be for all income and excess-profits tax purposes, but not for the purposes of the declared value excess-profits tax and the capital stock tax. In lieu of any adjustment with respect to the declared value excess-profits tax, there is imposed for the taxable year in which the gain was realized (see § 32.17) an additional tax of 1.1 percent of the amount of the gain. No additional capital stock tax liability is incurred.

(b) In the case of deposits in the construction reserve fund of amounts derived from sources other than those specified in the statute, or in the case of failure to deposit an amount equal to the "net proceeds" or "net indemnity" within the prescribed statutory period, the taxpayer obtains no suspension or postponement of any tax liability and the tax is collectible without regard to the provisions of the statute. (See § 32.13.)

(c) If an election is made under subdivision (c) (2) of section 511, as amended, and § 32.12 (b) (2), and if computation or recomputation in accordance therewith is otherwise allowable but is prevented, on the date of filing of notice of such election, or within six months thereafter, by any statute of limitation, such computation or recomputation nevertheless shall be made notwithstanding such statute if a claim therefor is filed within six months after the date of making such election. If as the result of such computation or recomputation an overpayment is disclosed, a claim for refund on Form 843 should also be filed within such six months' period.

[T. D. 5330, 9 F. R. 1088, as amended by T. D. 5445, 10 F. R. 2608]

§ 32.23 *Assessment and collection of deficiencies.* Any additional tax, including the 1.1 percent of the amount of the gain imposed in lieu of declared value excess-profits tax, due on account of withdrawal from a construction reserve fund, or failure to comply with the provisions of the statute or the regulations, is collectible as a deficiency. Interest upon such deficiency will run from the date the withdrawal or noncompliance occurs. The amount of any deficiency, including interest and additions to the tax, determined as a result of such withdrawal or noncompliance, may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time and without regard to any period of limitations or any other provisions of law or rule of law, including the doctrine of res judicata.

§ 32.24 *Reports by taxpayers.* (a) With each income tax return filed for a taxable year during any part of which a construction reserve fund is in existence the taxpayer shall submit a statement setting forth a detailed analysis of such fund. The statement, which need not be on any prescribed form, shall include the following information with respect to the construction reserve fund:

(1) The actual balance in the fund at the beginning and end of the taxable year;

(2) The date, amount, and source of each deposit during the taxable year;

(3) If subparagraph (2) of this paragraph (2) consists of proceeds from the sale, or indemnification of loss, of a vessel or share thereof, the amounts of the unrecognized gain;

(4) The date, amount and purpose of each expenditure or withdrawal from the fund; and

(5) The date and amount of each contract, under which deposited funds are deemed to be obligated during the taxable year, for construction or acquisition of a new vessel and the identification of such vessel.

(b) Taxpayer shall keep such records and make such additional reports as the

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Commissioner of Internal Revenue or the Maritime Commision may require.

§ 32.25 *Construction or acquisition by controlled corporation.* For the purposes of the statute and the regulations in this part a new vessel is considered as constructed or acquired by the taxpaper if constructed or acquired by a corporation at a time when the taxpayer owns not less than 95 percent of the total number of shares of each class of stock of the corporation.

§ 32.26 *Basis of new vessel.* The basis for determining gain or loss and for depreciation for the purpose of Federal income or excess-profits taxes with respect to a new vessel constructed or acquired by the taxpayer with funds deposited in the construction reserve fund, is reduced by the amount of the unrecognized gain represented in the funds allocated under the provisions of the regulations in this part to the cost of such vessel. (See § 32.17.)

§ 32.27 *Administrative jurisdiction.* Sections 32.3 to 32.11, inclusive, and §§ 32.18 to 32.20, inclusive, deal primarily with matters under the jurisdiction of the Maritime Commission. Sections 32.12, 32.16, and 32.17 and §§ 32.21 to 32.26, inclusive, deal primarily with matters under the jurisdiction of the Commissioner of Internal Revenue. Generally, matters relating to the establishment, maintenance, expenditure, and use of construction reserve funds and the construction or acquisition of new vessels are under the jurisdiction of the Maritime Commission; and matters relating to the determination, assessment and collection of taxes are under the jurisdiction of the Commissioner of Internal Revenue. Correspondence should be addressed to the particular authority having jurisdiction in the matter.

Part 37—Carry-Overs of Railroads

Sec.
37.1 Allowance of carry-overs to certain successor railroad corporations.
37.2 Limitation on effect of carry-overs.
37.3 Rule where two or more predecessors or two or more successors.
37.4 Extension of period of limitation on refunds and deficiencies.

AUTHORITY: §§ 37.1 to 37.4 issued under 53 Stat. 467, 61 Stat. 324; 26 U. S. C. and Sup., 3791, 122 note.

SOURCE: §§ 37.1 to 37.4 contained in T. D. 5642, 13 F. R. 3861.

§ 37.1 *Allowance of carry-overs to certain successor railroad corporations*—(a) *In general.* (1) The act applies only to railroad corporations (as defined in section 77m of the National Bankruptcy Act, as amended) which acquired, prior to January 1, 1950, property of one or more other railroad corporations (as so defined) in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, as amended, and where the basis of the property so acquired is determined under section 113 (a) (20) of the Code. A railroad corporation which has thus acquired property is referred to in this part as the "successor corporation" or the "successor" and the corporation from which the property was so acquired is referred to as the "predecessor corporation" or the "predecessor".

(2) In the case of a successor corporation, the net operating losses and unused excess profits credits of the predecessor corporation are allowed, as provided under section 1 of the act and the regulations in this part, as carry-overs to the successor corporation for the purposes of the determination under the Code of the "net operating loss carry-over" from any taxable year beginning after December 31, 1938, and the "excess profits credit carry-over" and the "unused excess profits credit carry-over" from any taxable year beginning after December 31, 1939, in each case under the law applicable to such taxable year. Thus, the method of computation of the carry-overs as well as the years for which such carry-overs are available (except as provided in subsections (b) and (c) of section 1 of the act) and the computation of the net operating loss deduction and the unused excess profits credit adjustment (called the "excess profits credit carry-over" for taxable years beginning in 1940) are governed by the provisions of the applicable law under the Code.

(3) In general, the carry-over to which the predecessor was entitled at the time of the acquisition will be available to the successor. Moreover, in general the successor corporation will not be allowed a carry-over for a taxable year, or a carry-over from a taxable year, which would not be allowed to the predecessor corporation under the Code if the predecessor corporation had been made use of under the receivership proceedings or the proceedings under section 77 of the Bankruptcy Act instead of the successor cor-

poration. Thus, except as provided in subsections (b) and (c) of section 1 of the act, carry-overs will be allowed as provided under the Code only for the two immediately succeeding taxable years, and carry-overs will not be created from any year if the otherwise applicable provisions of the Code provide no carry-over from such year. For example, a net operating loss carry-over will not be allowed from a taxable year beginning prior to January 1, 1939, and will not be allowed from any subsequent year if a carry-over from such year would not be allowed under the Code to the reorganized railroad corporation if it had come out of the receivership or bankruptcy proceeding under the same charter instead of being reorganized under a new charter.

(4) The provisions of subsection (a) of section 1 of the act to the effect that there shall be carried over to the successor corporation the net operating losses and unused excess profits credits of the predecessor corporation from the second taxable year preceding its taxable year in which acquisition occurred are applicable as to such second preceding year only if subsection (c) of section 1 of the act is applicable. See paragraph (c) of this section.

(5) Section 1 of the act does not apply to any carry-back of a successor corporation or of a predecessor corporation. Thus, a net operating loss or unused excess profits credit of a successor corporation cannot be carried back for the use of a predecessor corporation. As to a limitation on the reduction of tax of the successor corporation for a taxable year for which it has a carry-back, where such carry-back is made available or increased in amount by reason of the use in a prior taxable year of a carry-over provided for by section 1 of the act, see section 2 of the act and § 37.2.

(6) For application of section 1 of the act and of this section where there are two or more predecessor corporations or two or more successor corporations, see section 3 of the act and § 37.3.

(b) *Rules for determining manner and extent of allowance of carry-overs to successor corporation.* (1) The net operating losses and unused excess profits credits of a predecessor corporation shall be carry-overs to its successor corporation in the manner and to the extent provided in the act and in the regulations in this part so far as possible as if the predecessor corporation had been made use of in the receivership or bankruptcy proceeding instead of the successor corporation.

(2) In determining the taxable years for which there are such carry-overs, the taxable year of the successor in which the acquisition occurred is the first taxable year succeeding the taxable year of the predecessor in which the acquisition occurred and subsequent taxable years of the successor follow in order. Any such succeeding taxable year may also be an "intervening" taxable year for the purposes of the application of sections 122 and 710 (c) of the Code. As a general rule, therefore, a net operating loss or unused excess profits credit of the predecessor corporation:

(i) For the taxable year of the predecessor immediately preceding its taxable year in which the acquisition occurred, will be a carry-over for the taxable year of the predecessor in which the acquisition occurred and for the taxable year of the successor in which the acquisition occurred;

(ii) For the taxable year of the predecessor in which the acquisition occurred, will be a carry-over for the taxable year of the successor in which the acquisition occurred and for the next immediately succeeding taxable year of the successor following such taxable year of the successor in which the acquisition occurred.

(3) A variation from such general rule stated in the immediately preceding sentence may arise under the special rule of subsection (c) of section 1 of the act, under which there may be a carry-over for three taxable years. For application of this special rule, see paragraph (c) of this section.

(4) Another variation to the above stated general rule may arise in cases in which the predecessor has continued after the acquisition with a taxable year or taxable years subsequent to the taxable year of the predecessor in which the acquisition occurred. In such cases, the carry-overs shall not be denied to the predecessor for such subsequent year or years if available to the predecessor under the otherwise applicable law. However, the amount of any net operating loss or unused excess profits credit of the predecessor available as a carry-over to the successor under section 1 of the act shall be reduced in order to prevent duplication of the use of a carry-over.

Such reduction shall be the amount by which such carry-over would be reduced if such subsequent year or years of the predecessor were an intervening taxable year or intervening taxable years of the successor, succeeding the taxable year of the predecessor in which the acquisition occurred and preceding the taxable year of the successor in which the acquisition occurred. Notwithstanding this treatment, however, such subsequent year or years of the predecessor shall not be counted for the purpose of determining the number of years for which there may be such a carry-over to the successor. The method of computing a carry-over where there is more than one intervening taxable year is set forth in paragraph (c) of this section and this method shall be applicable for the purposes of this paragraph. The pro rata reduction of the adjusted excess profits net income for an intervening taxable year provided for in certain cases under paragraph (c) of this section where the intervening taxable year is a period of less than 12 months is applicable, however, only where such an intervening taxable year is a taxable year in which the acquisition occurred and is not applicable to subsequent taxable years of the precedessor which are considered intervening taxable years for the purposes of this paragraph.

(5) There are no carry-overs to a successor corporation under this section from a predecessor corporation's taxable year beginning after the taxable year of the predecessor in which the acquisition occurred. Moreover, the net operating losses and unused excess profits credits of the predecessor shall not be carry-overs for any taxable year of the successor prior to the taxable year of the successor in which the acquisition occurred.

(6) In applying section 1 of the act, the computation of the taxes of the successor corporation shall be made under the facts as they actually exist in the case of the successor corporation, except for the allowance of the carry-overs provided for by the act. The amounts to be included on account of such carry-overs in the net operating loss deduction and unused excess profits credit adjustment (called the "excess profits credit carry-over" for taxable years beginning in 1940) of the successor for its taxable year in which the acquisition occurred (except as provided in subparagraph (4) of this paragraph to prevent duplication and except as provided in paragraph (c) of this section) shall be the same amounts as would be included if such taxable year were the taxable year of the predecessor immediately succeeding the taxable year of the predecessor in which the acquisition occurred, except that the reduction of such carry-overs required under section 122 (c) in determining the net operating loss deduction shall be made upon the basis of the net income and normal tax net income (both computed as provided in section 122 (c)) of the successor corporation. If the taxable year of the successor immediately following its taxable year in which the acquisition occurred is the second succeeding taxable year for which there is a carry-over, the amounts to be included for such taxable year (except as provided in subparagraph (4) of this paragraph to prevent duplication and except as provided in paragraph (c) of this section) shall be the same amounts as if such year were the second succeeding taxable year of the predecessor to which there was such carry-over, except that the reduction under section 122 (c) and the reduction relating to intervening years provided for under sections 122 (b) (2) and 710 (c) (3) (B) (or section 710 (c) (2) for taxable years beginning in 1940) shall be made upon the basis of the items of the successor.

The operation of the above provisions of the regulations in this part may be illustrated by the following example:

Example. The A Railroad Corporation, which made its returns on the calendar year basis, for 1941 sustained a net operating loss of $100,000 and had an unused excess profits credit of $1,000,000. A did not have any carry-overs from any prior years. The B Railway Corporation was organized on July 1, 1941, and made its first return on the basis of the fiscal year ended June 30, 1942. It received permission to change its accounting period to a calendar year basis and made returns for the short taxable year, July 1, 1942–December 31, 1942, and for the calendar year 1943. On August 31, 1941, B acquired all the assets of A, the basis of which is determined under section 113 (a) (20) of the Code. A terminated its existence as of December 31, 1941. B did not have any net operating loss or any unused excess profits credit from its operations.

The net operating loss of A for 1941 is a net operating loss carry-over of B for its fiscal year ended June 30, 1942, and for its short taxable year ended December 31, 1942, but not thereafter. The net operating loss carry-over for B's fiscal year ended June 30,

1942, is $100,000; and the net operating loss deduction of B for such fiscal year is such carry-over reduced, however, by the amount, if any, by which B's net income for such fiscal year exceeds B's normal tax net income for such fiscal year, both being computed as provided under the applicable provisions of section 122 (c) of the Code. The net operating loss carry-over for the short taxable year ended December 31, 1942, is the excess of $100,000, if any, over the net income of B for its fiscal year ended June 30, 1942, computed as provided in section 122 (b) (2) of the Code under the applicable law; and the net operating loss deduction of B for such short taxable year is such excess, reduced, however, by the amount, if any, by which B's net income for such short year exceeds B's normal tax net income for such short year, both being computed as provided under the applicable provisions of section 122 (c) (and section 47 (c), relating to income placed on an annual basis).

The unused excess profits credit of A for 1941 is an unused excess profits credit carry-over of B for its fiscal year ended June 30, 1942, and for its short taxable year ended December 31, 1942, but not thereafter. The unused excess profits credit carry-over for B's fiscal year ended June 30, 1942, is $1,000,000 and the unused excess profits credit adjustment for such fiscal year is such carry-over. The unused excess profits credit carry-over for the short taxable year ended December 31, 1942, is the excess, if any, of $1,000,000 over the adjusted excess profits net income of B for its fiscal year ended June 30, 1942 (computed as provided in section 710 (c) (3) (B) of the Code under the applicable law), and the unused excess profits credit adjustment of B for such short taxable year is such excess.

(c) *Special rule where taxable years of predecessor and successor in which acquisition occurred begin and end in same period of not more than 12 months.* (1) Under subsection (c) of section 1 of the act it is possible to have a carry-over for three taxable years. The provisions of subsection (c) of section 1 apply only where the period beginning on the first day of the taxable year of the predecessor corporation in which the acquisition occurred and ending on the last day of the taxable year of the successor corporation in which the acquisition occurred is not more than 12 months. In such a case, where a net operating loss or an unused excess profits credit of the predecessor arose in:

(i) The predecessor's taxable year in which the acquisition occurred, there may be a carry-over for the successor's taxable year in which the acquisition occurred and for its next two taxable years;

(ii) The predecessor's first taxable year preceding its taxable year in which the acquisition occurred, there may be a carry-over for the successor's taxable year in which the acquisition occurred and for its next taxable year;

(iii) The predecessor's second taxable year preceding its taxable year in which the acquisition occurred, there may be a carry-over for the successor's taxable year in which the acquisition occurred.

(2) The rule of subsection (c) of section 1 is directed to situations in which, in effect, the period in which fall the taxable years (of predecessor and of successor) in which the acquisition occurred would have been but one taxable year of the predecessor if the railroad had been reorganized under the old charter. Frequently one or both of such taxable years in which the acquisition occurred are periods of less than twelve months, but such periods nevertheless are counted as taxable years for the purpose of determining the number of years for which carry-overs are permitted.

(3) In any case in which there is a carry-over to a third succeeding taxable year under subsection (c) of section 1 of the act, it is necessary to treat each of the first and second taxable years succeeding the taxable year in which the net operating loss or unused excess profits credit arose as intervening taxable years for purposes of section 122 (b) (2) and section 710 (c) (3) (B). In applying these sections of the Code, the carry-over for the third succeeding taxable year shall be the excess, if any, of the carry-over for the second succeeding taxable year over, in the case of a net operating loss carry-over, the net income for the second succeeding taxable year (computed as provided in section 122 (b) (2)), or, in the case of an unused excess profits credit carry-over, the adjusted excess profits net income for the second succeeding taxable year (computed as provided in section 710 (c) (3) (B)).

(4) The application of subsection (c) of section 1 may be illustrated by the following example:

Example: The M Railroad Corporation is the predecessor corporation and the N Railway Corporation is the successor corporation, both within the meaning of the act, with N having acquired the property of M on May 31, 1941. Both M and N make their returns on the calendar year basis. N was organized on April 1, 1941, and made its first return for the short taxable year, April 1, 1941–December 31, 1941. M was dissolved on August 31,

1941, and made its last return for the short taxable year ending on that date.

For 1940 M sustained a net operating loss in the amount of $150,000, and for its short taxable year ended August 31, 1941, it had net income, computed as provided in section 122 (b) (2), of $50,000. For N's short taxable year ended December 31, 1941, it had $70,000 of net income (and no adjustments under section 122 (d) (1), (2), (4) and (6) are applicable. There are no carry-backs.

Under the above facts, there is a carry-over of $150,000 for the taxable year of M ended August 31, 1941. There is a carry-over to N for its first taxable year (ended December 31, 1941) of $100,000 (that is, the excess of $150,000 over $50,000). There is a carry-over to N for its taxable year ended December 31, 1942, of $30,000 (that is, the excess of $100,000 over $70,000).

(5) In the application of subsection (c) of section 1, additional steps are necessary in some cases in computing the unused excess profits credit carry-over for the taxable year of the successor in which the acquisition occurred and for succeeding taxable years of the successor. In a case where the taxable year in which the acquisition occurred (of the predecessor or successor) is a period of less than twelve months, then under section 711 (a) (3) of the Code the excess profits net income for such short taxable year is required to be computed upon the basis of a period of 12 months, and accordingly the adjusted excess profits net income is on an annual basis. In such a case under subsection (c) of section 1 of the act, the adjusted excess profits net income for such a short taxable year (of the predecessor or successor, or such short taxable years of both, as the case may be, taken separately), when computed for the purposes of section 710 (c) (3) (B) (for an intervening taxable year) shall be reduced to an amount which is the same proportion thereof as the excess profits net income for the short taxable year is of the excess profits net income for such short taxable year computed on an annual basis.

(7) The application of the above rule in cases under subsection (c) of section 1 involving unused excess profits credit carry-overs is illustrated by the following example:

Example: The X Railroad Corporation and Y Railroad Corporation make their returns on the calendar year basis. For 1943, X had an unused excess profits credit (after being reduced by reason of its use as a carry-back as provided in section 710 (c) (3) (B) of the Code) of $60,000 available as a carry-over. Y was organized and commenced business on July 2, 1944. The property of X (the predecessor) was acquired by Y (the successor) on August 31, 1944. X was dissolved on August 31, 1944.

For its taxable year ending August 31, 1944, X had an excess profits credit of $336,000 and an excess profits net income of $244,000 before being placed on an annual basis. For its short taxable year ending December 31, 1944, Y had an excess profits credit of $224,000 and an excess profits net income of $122,000 before being placed on an annual basis. Y had no carry-backs for any year.

X will pay no excess profits tax for its taxable year ending August 31, 1944, as shown by the following computation:

Excess profits net income placed on an annual basis under section 711 (a) (3) (A)		$366,000
Specific exemption	$10,000	
Excess profits credit	336,000	
Unused excess profits credit adjustment	60,000	406,000
Adjusted excess profits net income		0

The unused excess profits credit adjustment of Y will be the amounts of the carry-overs computed below:

For the Short Taxable Year Ending December 31, 1944

(1) Unused excess profits credit of X	$60,000
(2) Adjusted excess profits net income of X for its taxable year ending August 31, 1944, computed for the purposes of section 710 (c) (3) (B) ($366,000 less $336,000)	30,000
(3) Amount in (2) placed on basis of X's short taxable year ended August 31, 1944 (244/366ths of $30,000)	20,000
(4) Unused excess profits credit carry-over for short taxable year of Y ending December 31, 1944 (excess of amount in (1) over amount in (3))	40,000

For the Taxable Year Ending December 31, 1945

(i) Unused excess profits carry-over for second intervening year (item (4) in computation for year ended December 31, 1944)	$40,000
(ii) Excess profits net income of Y for its taxable year ended December 31, 1944, placed on an annual basis as provided in section 711 (a) (3) (A) of the Code	244,000
(iii) Adjusted excess profits net income of Y for its taxable year ended December 31, 1944, computed for the purposes of section 710 (a) (3) (B) ($244,000 less $224,000)	20,000
(iv) Amount in (iii) placed on basis of Y's short taxable year ended December 31, 1944 (183/366ths of $20,000)	10,000

(v) Unused excess profits credit carry-over for the taxable year of Y ended December 31, 1945:		
Unused excess profits credit carry-over for second intervening taxable year (item (i))	$40,000	
Less:		
Adjusted excess profits net income for second intervening taxable year (item (iv))	10,000	
		$30,000

§ 37.2 *Limitation on effect of carry-overs.* (a) Section 2 of the act limits the effect of the carry-overs otherwise permitted under section 1 of the act, both for any taxable year of the successor corporation for which there is a carry-over permitted by section 1 of the act and for certain later taxable years described below.

(b) Subsection (a) of section 2 provides for a comparison of the aggregate of the income and excess profits taxes of the successor corporation for any taxable year, determined without regard to any carry-overs permitted by this act, with the aggregate of the income and excess profits taxes that wonld have been imposed on the predecessor corporation for such taxable year if the predecessor corporation had been made use of in the proceeding instead of the successor corporation. If for any taxable year the successor's aggregate so determined without regard to the carry-overs permitted by the act is less than the aggregate of the predecessor for such year, then any carry-over permitted by the act shall be disregarded in computing the successor's taxes for such taxable year.

Subsection (b) of section 2 provides that if the successor's aggregate as determined in the preceding paragraph, though not less than the aggregate of the predecessor, would be reduced to a lesser amount than the predecessor's aggregate by an application of section 1 of the act (which permits a carry-over), then the successor's taxes for that year shall be the taxes that would have been imposed on the predecessor corporation, that is, the same amounts as the taxes that make up the predecessor's aggregate.

(c) Subsection (c) of section 2 provides that subsections (a) and (b), described above, shall apply to those taxable years of the successor corporation for which there is a carry-over under section 1, and to any later taxable year for which a net operating loss deduction or unused excess profits credit adjustment results or is increased by reason of the use in another year of such a carry-over. Thus, for example, if a net operating loss carry-over from the predecessor corporation to the successor corporation, which is on the calendar year basis is permitted under section 1 for 1941, section 2 of the act applies to 1941. If there is an unused excess profits credit carry-over for 1942 from 1941, which is increased by the net operating loss carry-over from the predecessor for 1941, then section 2 applies to 1942. If there is an unused excess profits credit for 1944 which is a carry-back for 1942 and 1943, and if the amount of the carry-back for 1943 (the portion of the carry-back which is not applied against adjusted excess profits net income for 1942) is increased by reason of the unused excess profits credit carry-over for 1942 which in turn was increased by the net operating loss carry-over from the predecessor corporation to the successor corporation for 1941, then section 2 also applies to 1943.

(d) Section 2 of the act is operative only to limit the net tax reduction that would otherwise result from an application of the provisions of section 1 of the act. Any carry-overs permitted by section 1 are considered as having been used for the year to which section 2 applies to the extent that they would have been used had section 2 not been applicable.

(e) The comparisons required to be made under this section shall first be made for the taxable year of the successor in which the acquisition occurred. The taxes that would have been imposed on the predecessor corporation had it been made use of in the proceeding instead of the successor corporation shall be determined by adjusting the items which enter into the computation of the successor corporation's taxes to accord with the amounts such items would have been for such taxable year if the charter of the predecessor corporation had been used. The comparisons shall be made on the basis of the taxable year of the successor in which the acquisition occurred. Such adjustment shall be made in the items which enter into the computation of the successor's taxes as are necessary to give effect for the period of its taxable year on and after the date of the acquisition to such computations as would be proper for the predecessor for such period

if the predecessor had not transferred the property and had continued under its old charter for such period. Similar adjustments shall be made for all taxable years of the successor subsequent to the acquisition, following in order, for which comparisons are required to be made under this section, regardless of the accounting periods of the predecessor or whether the predecessor continues in existence.

(f) The adjustments in the items of the successor referred to immediately above and in this paragraph are to be made for the purposes of determining the taxes that would have been imposed on the predecessor corporation and are not actual adjustments to be made for all purposes in determining the taxes of the successor. If the successor corporation uses a different method of computing depreciation from the predecessor corporation or if the successor corporation uses a depreciation method of accounting and the predecessor used the retirement method, adjustments shall be made to the extent which would be required if the successor corporation had first been bound by the predecessor corporation's method and had then changed its method to that of the successor, with the adjustments required for such change, after obtaining the permission of the Commissioner. If the same depreciation method is used by the predecessor and the successor, then the depreciation shall be computed in the same manner as the successor would have been required to compute it if it were the predecessor operating under the predecessor's charter, that is, by using the same reserves and the same percentages as would have been proper in such case. Similarly, the excess profits credit of the successor shall be adjusted to reflect the excess profits credit which it would have if its capital structure were obtained by using the predecessor's charter and making the necessary changes in the capital structure of the predecessor. Furthermore, adjustments shall also be made by including or excluding such additional items as would be included or excluded if the charter of the predecessor were used. Thus, if the predecessor were incorporated in State A, and the successor in State B, and if the State taxes imposed on the successor are greater than the taxes which would be imposed if it were incorporated in State A, then the deduction for State taxes shall be the amount which would be imposed if the corporation were incorporated in State A.

(g) Section 2 may be illustrated by the following examples in which it is assumed that the corporations made their returns on the calendar year basis:

Example (1). As of the beginning of January 1, 1942, the successor corporation acquired all the properties of the predecessor corporation, the predecessor corporation being dissolved immediately thereafter. The successor corporation was a new corporation having no capital, no income, and no deductions prior to this acquisition. For 1942, under section 1 of the act the successor is allowed a net operating loss carry-over and an unused excess profits credit carry-over from its predecessor. There are no other carry-overs or carry-backs. The taxes of the successor for 1942 computed without regard to the carry-overs provided by the act are as follows:

Excess profits tax	$1,800,000
Normal tax	1,920,000
Surtax	1,280,000
Aggregate of taxes	5,000,000

Assume for the purpose of this example that, if the predecessor corporation had been used in place of the successor in the proceeding, its deductions and its excess profits credit would be less than that of the successor. The taxes that would have been imposed upon the predecessor for 1942, computed with its carry-overs, had it been used in place of the successor are as follows:

Excess profits tax	$2,250,000
Normal tax	1,920,000
Surtax	1,280,000
Aggregate of taxes	5,450,000

Since the aggregate of the taxes imposed on the successor without regard to the act ($5,000,000) is less than the aggregate that would have been imposed on the predecessor if it had been used in place of the successor ($5,450,000), the successor is not entitled to any carry-over under the act in computing its taxes for the taxable year 1942.

Example (2). In this example, involving the same corporations for the same taxable year, as in example (1), there is no net operating loss carry-over from the predecessor corporation but there is an unused excess profits credit carry-over, and the excess profits credit of the predecessor if it had been used in place of the successor is more than such credit in example (1). The taxes that would have been imposed on the predecessor for 1942 are as follows:

Excess profits tax	$900,000
Normal tax	2,160,000
Surtax	1,440,000
Aggregate of taxes	4,500,000

Section 2 (a) of the act, illustrated in example (1), does not apply since the aggregate of the taxes imposed on the successor without regard to the act ($5,000,000) is not less than the aggregate that would have been imposed on the predecessor had it been used in place of the successor in the proceeding ($4,500,000). However, the taxes of the successor computed with the carry-overs for 1942 provided by section 1 of the act are as follows:

Excess profits tax	----------
Normal tax	$2,400,000
Surtax	1,600,000
Aggregate of taxes	4,000,000

The aggregate of the taxes of the successor computed with the carry-overs provided by section 1 of the act ($4,000,000) is less than the aggregate of the taxes that would have been imposed on the predecessor if it had been used in the proceeding in place of the successor ($4,500,000). Subsection (b) of section 2 provides that in such a case, where subsection (a) of section 2 does not apply, the taxes of the successor corporation shall be the taxes that would have been imposed on the predecessor corporation if it had been so used in place of the successor. Accordingly, the taxes of the successor corporation for the taxable year 1942 are as follows:

Excess profits tax	$900,000
Normal tax	2,160,000
Surtax	1,440,000

If in this example the aggregate of the taxes of the successor computed with the carry-overs provided by section 1 of the act had not been less than the aggregate of the taxes that would have been imposed on the predecessor if it had been used in the proceeding in place of the successor, the taxes of the successor would be its taxes computed with the carry-overs provided by section 1.

Example (3). In this example the taxes are computed for 1943, and the facts as to 1942 are the same as in example (2). There is no unused excess profits credit carry-over for 1943 as computed under section 710 (c) (3). Although section 2 (b) operated to limit the tax reduction for 1942 which would have resulted from the full use of the carry-over for 1942, the extent to which the carry-over is considered used is computed under section 710 (c) (3) without regard to that limitation. The successor corporation had an unused excess profits credit for 1944 which is a carry-back for 1942 and 1943. Since the amount of the carry-back for 1943 depends on the extent to which the carry-back was used for 1942, and since such use depends on the effect of the carry-over for 1942 permitted under section 1 of the act, subsection (c) of section 2 requires that section 2 be applied as a limitation on the tax for 1943. Accordingly, the tax of the successor corporation for 1943 must be computed first without regard to the carry-over under section 1 for 1942. The taxes of the successor so computed for 1943 are as follows:

Excess profits tax	$450,000
Normal tax	2,280,000
Surtax	1,520,000
Aggregate of taxes	4,250,000

The taxes of the predecessor corporation for 1943 must be computed also with the carry-back which would be applicable in the case of the predecessor corporation (if it had been used in the proceeding in place of the successor corporation) taking into account the use of the carry-back for 1942 as affected by the carry-over for 1942. The taxes of the predecessor corporation for 1943 as so computed are:

Excess profits tax	$1,350,000
Normal tax	2,040,000
Surtax	1,360,000
Aggregate of taxes	4,750,000

Since the aggregate of the taxes of the successor for 1943 computed without regard to the carry-overs provided by the act ($4,250,000) is less than the aggregate of the taxes which would be imposed on the predecessor if it had been used in place of the successor ($4,750,000) section 2 (a) provides that the taxes of the successor are to be computed without regard to the carry-over permitted under the act. Accordingly, such taxes will be the amounts shown above as the taxes of the successor computed without regard to the carry-overs permitted by the act.

§ 37.3 *Rule where two or more predecessors or two or more successors*—(a) *Allowance of carry-overs*—(1) *Two or more predecessor corporations.* If the successor corporation has acquired the properties of two or more other railroad corporations so that each of the latter are predecessor corporations within the meaning of the act, then section 1 of the act and § 37.1 shall be applied to the carry-over from any such predecessor corporation. If there are carry-overs from more than one predecessor corporation, then the following rules shall apply:

(i) There shall be determined under § 37.1 for each predecessor corporation both (*a*) those taxable years of the successor to which such carry-over or carry-overs are permitted, and (*b*) the amount of the carry-over or carry-overs from such predecessor for the taxable year of the successor in which the acquisition occurred.

(ii) If for any taxable year in which an acquisition occurred amounts are allowed as net operating loss carry-overs or unused excess profits credit carry-overs from two or more predecessor corporations, such amounts in each case shall

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be aggregated and treated as one net operating loss carry-over or unused excess profits credit carry-over, as the case may be, for such taxable year and for each succeeding taxable year for which the carry-overs making up the aggregate are permitted, reduction being made for such succeeding year for the use of the carry-over in the intervening year or years. If for any succeeding taxable year one or more but not all of such carry-overs are permitted, then the amount of the carry-over permitted (or aggregate of the carry-overs, if more than one) shall be computed by taking into account in determining the net income, or adjusted excess profits net income, as the case may be, for any intervening taxable year the carry-overs permitted for such intervening taxable year which are not permitted for the succeeding taxable year.

An example of the operation of the above rules is given in the following case:

Example: The X Corporation which makes its returns on the calendar year basis, was organized on January 1, 1944. X acquired on April 1, 1944, the properties of the A Corporation and of the B Corporation, and on June 30, 1945, the properties of the C Corporation so as to be the successor of A, B, and C within the meaning of the act.

The A Corporation, which made its returns on the calendar year basis, had a net operating loss for 1942, which, after reduction by its use as a carry-back (section 122 (b) (2)), was $100,000. A had net income for 1943 of $30,000 and for 1944 of $50,000, both computed without regard to such net operating loss. A was dissolved as of December 31, 1944.

The B Corporation, which made its returns on the calendar year basis, had a net operating loss for 1944 which, after reduction by its use as a carry-back (section 122 (b) (2)), was $30,000. B was dissolved as of December 31, 1944.

The C Corporation, which made its returns on the basis of a fiscal year ending June 30, had a net operating loss for its fiscal year ending June 30, 1945, which, after reduction by its use as a carry-back (section 122 (b) (2)), was $90,000. C was dissolved as of June 30, 1945.

The net income of X without regard to any net operating loss deduction is $25,000 for 1944 and $80,000 for 1945. X has no carry-backs.

The adjustments provided for under section 122 (d) (1), (2), (4), and (6) are not applicable in the case of the net income of X, A, B, and C.

Under § 37.1, the net operating loss of A is a carry-over to X for 1944, the year of acquisition.

The amount of such carry-over is $20,000 computed as follows:

Net operating loss for 1942	$100,000
Net income of A for 1943 (computed as provided in section 122 (b) (2) for an intervening year)	30,000
Net operating loss carry-over for 1944 (second succeeding taxable year)	70,000
Net income for 1944 (computed under section 122 (b) (2); see § 37.1 (c))	50,000
Net operating loss carry-over to X for 1944 (see § 37.1)	20,000

Under § 37.1 the net operating loss of B is a carry-over to X for 1944, the year of acquisition, and for 1945 and 1946, the next two succeeding taxable years. The amount of such carry-over to X for 1944 is $30,000, the net operating loss of B for 1944. Under § 37.1, the net operating loss of C for 1945 is a carry-over to X for 1945, the year of acquisition, and for 1946, the next succeeding taxable year. The net operating loss carry-over from C to X for 1945 is $90,000.

The net operating loss carry-over (from A and B) for X's taxable year 1944 is $50,000, computed as follows:

(a) Net operating loss carry-over from A's taxable year 1942	$20,000
(b) Net operating loss carry-over from B's taxable year 1944	30,000
(c) Aggregate of carry-overs for taxable year (items (a) and (b))	50,000

The net operating loss carry-over (from B and C) for X's taxable year 1945 is $115,000, computed as follows:

(1) Net operating loss carry-over from B for 1945:

Net operating loss carry-over from B for 1944, year of acquisition (item (b) above)	$30,000
Net income of X for intervening year 1944, computed without net operating loss deduction	25,000
Net operating loss deduction for intervening year 1944, taking into account carry-over from A permitted for 1944 but not for 1945	20,000
Net income for intervening year 1944 under section 122 (b) (2)	5,000
Carry-over from B for 1945	25,000
(2) Net operating loss carry-over from C	90,000
(3) Aggregate of carry-overs for the taxable year (items (1) and (2))	115,000

The net operating loss carry-over (from B and C) for X's taxable year 1946 is $35,000, computed as follows:

Aggregate of net operating loss carry-overs from B and C for 1945	$115,000
Net income for 1945, computed as an intervening year	80,000
Net operating loss carry-over for 1946	35,000

(2) *Two or more successor corporations.* If property of a railroad corporation has been acquired by two or more other railroad corporations so that each of the latter are successor corporations within the meaning of the act, then section 1 of the act and § 37.1 shall be applied to the carry-overs from the predecessor corporation. The net operating losses and unused excess profits credits of such predecessor shall be allowed as carry-overs to each of the successor corporations as provided in § 37.1, but only to the extent that such net operating losses and unused excess profits credits are attributable to the property of the predecessor so acquired by such successor. As a general rule, the net operating losses and unused excess profits credits of the predecessor shall be attributed to the property of the predecessor acquired by a successor in the ratio which the adjusted basis for determining loss of such property bears to the adjusted basis for determining loss of all the property of the predecessor, each determined as of the close of the taxable year for which there was such net operating loss or unused excess profits credit, or as of the date of acquisition if the loss or the unused credit arose in the year of acquisition. If, however, the successor establishes to the satisfaction of the Commissioner (and submits, unless waived by the Commissioner, appropriate consents by the other successors) an amount which, in the opinion of the Commissioner, both more clearly reflects the portion of the net operating loss or unused excess profits credit of the predecessor attributable to the property so acquired and does not duplicate the use of such loss or credit by another successor or the predecessor, such an amount may be used by the successor in the computation of the carry-over.

(b) *Limitations on effect of carry-overs.* (1) The limitations under section 2 of the act on the tax effect of carry-overs are applicable to the extent provided in this paragraph in cases where there are two or more predecessors or two or more successors. For this purpose, the rules of § 37.2 shall be applicable, expect as provided in this section.

(2) If a comparison in taxes for a taxable year prescribed under § 37.2 is to be made for a corporation which is the successor of two or more predecessors (see paragraph (a) (1) of this section), for the purposes of section 2 "the taxes that would have been imposed on the predecessor corporation for such taxable year if the predecessor corporation had been made use of in such proceeding instead of the successor corporation" shall be the aggregate of the totals of each tax of the predecessors for the taxable year for which the comparison is to be made, determined as to each such predecessor as provided in § 37.2. The successor must accordingly establish with respect to each such predecessor the taxes that would have been imposed on such predecessor for such taxable year as if the predecessor corporation had emerged from the bankruptcy or receivership proceeding with its old charter and continued its separate existence.

The following specific rules are also applicable:

(i) The elections, methods of accounting, etc., of the successor shall be considered as if made or used by each predecessor, subject to such conditions as would be imposed in the case of the predecessor;

(ii) In the case of any acquisition of additional property and other transactions by the successor (after the acquisition of the predecessors' property), all such acquisitions and transactions shall be considered to have been made by the predecessors, with particular acquisitions and other transactions to be attributed to each predecessor on the basis of business reasons which might have motivated such predecessor so to act;

(iii) The aggregate of the separate totals may be adjusted to reflect the effect of additional factors established by the taxpayer, such as decreased overhead, if any, resulting from the operation of the properties of the separate predecessors by one corporation.

(3) If a comparison in aggregate taxes for a taxable year prescribed under § 37.2 is to be made for a corporation which is one of several successor corporations with respect to a predecessor (see paragraph (a) (2) of this section), then for the purposes of section 2 "the taxes that would have been imposed on the predecessor corporation for such taxable year

if the predecessor corporation had been made use of in such proceeding instead of the successor corporation" shall be determined as provided in § 37.2 by adjusting the items which enter into the computation of the successor's taxes to accord with the amounts such items would have been if the charter of the predecessor had been used and such predecessor had only the property of the successor.

§ 37.4 *Extension of period of limitation on refunds and deficiencies.* Section 4 of the act extends, for not more than one year after July 15, 1947, the period of limitation as to all years affected by the act if the refund or credit of any overpayment to the extent resulting from the application of the act is prevented on July 15, 1947, or within one year from such date, except where refund or credit is prevented by section 3761 of the Internal Revenue Code, relating to compromises. In such cases where section 4 extends the period of limitation, such overpayment shall be refunded or credited if claim therefor is filed within one year from July 15, 1947. Such overpayment shall be credited or refunded in the manner provided in the Internal Revenue Code. However, no interest shall be allowed or paid on any overpayment or deficiency resulting from the application of the act. If an overpayment resulting from the application of the act (for example, in an amount of excess profits tax) gives rise to a deficiency in a related tax (for example, in an amount of income tax) which deficiency, however, would be barred by the statute of limitations, such deficiency may be assessed and collected as provided in section 3807 of the Internal Revenue Code.

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Possessions of United States; income and excess profits taxes regulations. *See* Internal Revenue Bureau.

R

Railroads; income and excess profits taxes regulations. *See* Internal Revenue Bureau.
Registered investment companies, registered under Investment Company Act of 1940; income and excess profits taxes regulations. *See* Internal Revenue Bureau.

S

Sweden; income taxation pursuant to convention with. *See* Internal Revenue Bureau.

T

Treaties with various countries (Canada, France, Sweden, United Kingdom); income taxation pursuant to. *See* Internal Revenue Bureau.
Trusts and estates; income and excess profits taxes regulations. *See* Internal Revenue Bureau.

U

United Kingdom; income taxation pursuant to convention with. *See* Internal Revenue Bureau.

V

Vessels:
Construction reserve fund for, establishment of; income and excess profits taxes regulations. *See* Internal Revenue Bureau.
Income from operation of, by nonresident aliens; taxation pursuant to treaties with Canada, France, Sweden, United Kingdom. *See* Internal Revenue Bureau.
Naval vessels, excess profits on Navy contracts for; income and excess profits taxes regulations. *See* Internal Revenue Bureau.
Veterans; income tax provisions affecting members of armed forces. *See* Internal Revenue Bureau.