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TREASURY DEPARTMENT.

Bureau of Internal Revenue.

[Regulations 94]

Income Tax Under the Revenue Act of 1936

INTRODUCTORY

These regulations deal with the tax imposed on income by the Revenue Act of 1936.

Since these regulations deal only with the tax on income, certain parts of the Act, which are general in their nature, or which do not relate directly to the imposing and collecting of the tax, have not been printed in the body of these regulations, but have been inserted in the Appendix, where they are grouped and classified under proper headings. For this reason the main body of these regulations deals only with Titles I, IA, and VIII of the Act. Treasury Decision 4666, approved July 16, 1936, and Treasury Decision 4690, approved August 26, 1936, relating to the excess-profits tax imposed under Title I of the Revenue Act of 1935, as amended by Title II of the Revenue Act of 1936, have been printed in their entirety in the Appendix. The regulations under Title III of the Act, relating to the tax on unjust enrichment, have been promulgated as Regulations 95.

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

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

Certain important provisions of prior Revenue Acts from 1924 to date, together with important sections of the Revised Statutes relating to income tax, will be found in the Appendix, classified and grouped under the proper headings.

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CHAPTER I

Scope of Regulations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act, divided into titles and sections according to the following Table of Contents, may be cited as the "Revenue Act of 1936":

* * * * * * *

Title I—Income Tax, Subtitle A—Introductory Provisions

SEC. 1. *Application of title.*—The provisions of this title shall apply only to taxable years beginning after December 31, 1935. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1936, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior revenue Acts, except as such provisions are modified by legislation enacted subsequent to this Act.

ARTICLE 1-1. *Scope of regulations.*—These regulations deal with the taxes upon net income imposed by Title I of the Revenue Act of 1936, including the tax imposed by section 102 of Title I of that Act upon the net income of certain corporations, and the tax imposed by Title IA of that Act upon the undistributed adjusted net income of personal holding companies (see section 351).

The articles of these regulations have been given key numbers corresponding to the numbers of the sections, subsections, or paragraphs of the Act. For example, articles 23 (a)-1 to 23 (a)-12, relating to deduction for expenses, bear the key number 23 (a), which corresponds to subsection 23 (a) of the Act. The articles bearing a given key number are the regulations prescribed with respect to the corresponding section, subsection, or paragraph of the Act; and the section, subsection, or paragraph of the Act shall be considered as a part of the respective articles to which it corresponds.

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

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

Subtitle A—Introductory provisions,

Subtitle B—General provisions, divided into Parts and sections,

Subtitle C—Supplemental provisions, divided into Supplements and sections.

ART. 3-1. *Division of regulations.*—These regulations have been divided into 35 chapters. Chapter I relates to Introductory Provisions, Subtitle A of Title I. Chapters II to IX relate to General Provisions, Subtitle B of Title I. Chapters X to XXII relate to Supplements A to D of Supplemental Provisions, Subtitle C of Title I. Chapters XXIII to XXIX relate to Supplements E to K of Supplemental Provisions, Subtitle C of Title I. Chapters XXX to XXXIII relate to Supplements L to O of Supplemental Provisions, Subtitle C of Title I. Chapter XXXIV relates to Title IA, Surtax on Personal Holding Companies. Chapter XXXV relates to Title VIII, General Provisions of the Act.

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

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

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

Chapter XXIII—Estates and trusts.
Chapter XXIV—Partnerships.
Chapter XXV—Insurance companies.
Chapter XXVI—Nonresident alien individuals.
Chapter XVII—Foreign corporations.
Chapter XXVIII—Income from sources in possesions of the United States.
Chapter XXIX—China Trade Act corporations.

For provisions interpretative of section 351, surtax on personal holding companies, see articles 351-1 to 351-9, inclusive. For provisions relative to surtax on corporations improperly accumulating surplus, see articles 102-1 to 102-6.

CHAPTER II

Rates of Tax

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

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

ART. 11-1. *Income tax on individuals.*—Title I of the Act, which applies only to taxable years beginning after December 31, 1935 (see section 1), imposes an income tax on individuals, including a normal tax (section 11) and a surtax (section 12). The tax is upon net income which is determined by subtracting the allowable deductions from the gross income. (See generally sections 21-24.) In certain cases credits are allowed against the net income before computing the tax (section 25) and in other cases against the amount of the tax (sections 31, 32, and 131). In general, the tax is payable upon the basis of returns rendered by persons liable thereto (sections 51, 53, 142, and 217), except that in some instances it is to be paid at the source of the income (section 143). Exceptions and additional provisions applicable to certain special classes of taxpayers are listed in section 4. See section 102 as to shareholders of corporations formed or availed of to prevent imposition of surtax. See section 351 as to shareholders of personal holding companies. See section 117 as to treatment of capital gains and capital losses.

ART. 11-2. *Citizens or residents of the United States liable to tax.*—In general, citizens of the United States wherever

resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. As to nonresident alien individuals, see sections 211-219.

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

SEC. 12. *Surtax on Individuals.*—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(c) *Tax on personal holding companies.*—For surtax on personal holding companies, see section 351.

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

ART. 12–1. *Surtax.*—In addition to the normal tax imposed by section 11 a surtax is imposed at the rates specified in section 12 upon the surtax net income of every individual, resident or nonresident, except nonresident alien individuals subject to the tax imposed by section 211 (a). The surtax net income is the amount of the net income in excess of the personal exemption and credit for dependents. (See generally articles 25–1 to 25–7.) For surtax on corporations improperly accumulating surplus see section 102. As to surtax on personal holding companies, see section 351.

ART. 12–2. *Computation of surtax.*—The following table shows the surtax due for taxable years beginning after December 31, 1935, upon certain specified amounts of surtax net income. In each instance the first figure of the surtax net income in the surtax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the surtax net-income column. The last column gives the total surtax on a surtax net income equal to the second figure in the surtax net-income column.

Surtax Table

Surtax net income	Percent	Total surtax
$0 to $4,000		
$4,000 to $6,000	4	$80
$6,000 to $8,000	5	180
$8,000 to $10,000	6	300
$10,000 to $12,000	7	440
$12,000 to $14,000	8	600
$14,000 to $16,000	9	780
$16,000 to $18,000	11	1,000
$18,000 to $20,000	13	1,260
$20,000 to $22,000	15	1,560
$22,000 to $26,000	17	2,240
$26,000 to $32,000	19	3,380
$32,000 to $38,000	21	4,640
$38,000 to $44,000	24	6,080
$44,000 to $50,000	27	7,700
$50,000 to $56,000	31	9,560

Surtax Table—Continued

Surtax net income	Percent	Total surtax
$56,000 to $62,000	35	$11,660
$62,000 to $68,000	39	14,000
$68,000 to $74,000	43	16,580
$74,000 to $80,000	47	19,400
$80,000 to $90,000	51	24,500
$90,000 to $100,000	55	30,000
$100,000 to $150,000	58	59,000
$150,000 to $200,000	60	89,000
$200,000 to $250,000	62	120,000
$250,000 to $300,000	64	152,000
$300,000 to $400,000	66	218,000
$400,000 to $500,000	68	286,000
$500,000 to $750,000	70	461,000
$750,000 to $1,000,000	72	641,000
$1,000,000 to $2,000,000	73	1,371,000
$2,000,000 to $5,000,000	74	3,591,000
$5,000,000 up	75	

The surtax for any amount of surtax net income not shown in the table is computed by adding to the surtax for the largest amount shown which is less than the surtax net income, the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax due for taxable years beginning after December 31, 1935, upon a surtax net income of $63,128 would be $12,099.92, computed as follows:

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

SEC. 13. *Normal Tax on Corporations.*—

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of—

(1) *Interest on obligations of the United States and its instrumentalities.*—The credit provided in section 26 (a).

(2) *Dividends received.*—The credit provided in section 26 (b). Such credit shall not be allowed in the case of a mutual investment company, as defined in section 48.

(3) *Dividends paid.*—In the case of a mutual investment company the credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to dividend carry-over).

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:

Upon normal-tax net incomes not in excess of $2,000, 8 per centum.

$160 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 11 per centum in addition of such excess.

$1,590 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 13 per centum in addition of such excess.

$4,840 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 15 per centum in addition of such excess.

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

(d) *Banks and trust companies.*—For rate of tax on certain banks and trust companies, see section 104.

ART. 13–1. *Normal income tax on corporations.*—In general, the Act imposes a normal income tax on corporations at the graduated rates specified in section 13 (b). Every corporation is liable to the normal income tax at such graduated rates except (1) corporations expressly exempt from taxation under Title I of the Act (see section 101), (2) banks, as defined in section 104, (3) insurance companies (see sections 201, 204, and 207), (4) foreign corporations (see section 231), (5) domestic corporations entitled to the benefits of section 251 by reason of deriving a large portion of their gross income from sources within a possession of the United States, and (6) China Trade Act corporations (see Supplement K). It makes no difference that a domestic corporation subject to the graduated normal income tax imposed by section 13 (b) may derive no income from sources within the United States. The normal income tax on corporations is upon the normal-tax net income, that is, the net income as defined in section 21 minus the sum of (1) the credit provided in section 26 (a) for interest on obligations of the United States and its instrumentalities and (2) the credit for dividends received provided in section 26 (b), except that this credit is not allowed in the case of a mutual investment company, as defined in section 48 (e). In the case of a mutual investment company, for the purpose of the normal-tax net income, a credit is allowed against net income for dividends paid as provided in section 27, computed without the benefit of subsection (b) thereof, relating to the dividend carry-over.

The tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases it is to be paid at the source of the income. (See also sections 47, 52, 53, 144, and 235.) For surtax on undistributed profits of corporations, see section 14. For surtax on corporations improperly accumulating surplus, see section 102. As to surtax on personal holding companies, see section 351. For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 1001.

The following table shows the normal income tax due from corporations in general 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.

Corporation Normal Income Tax Table

Normal tax net income	Percent	Total tax
$0 to $2,000	8	$160
$2,000 to $15,000	11	1,590
$15,000 to $40,000	13	4,840
$40,000 up	15	

The normal tax 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. Accordingly, the normal tax due upon a normal-tax net income of $20,000 would be $2,240, computed as follows:

Tax on $15,000 from table	$1,590
Tax on $5,000 at 13 percent	650
Total	2,240

SEC. 14. *Surtax on Undistributed Profits.*—
(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.
(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.
(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).
(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.
12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.
17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.
22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.
27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted net income less than $50,000.*—

(1) *Specific credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).
(2) *Application of specific credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus
(B) 7 per centum of the amount of the specific credit.

(d) *Exemption from surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks as defined in section 104.
(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.
(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.
(4) Foreign corporations.
(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.
(6) Corporations organized under the China Trade Act, 1922.
(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) *Exempt corporations.*—For corporations exempt from taxation under this title, see section 101.
(f) *Tax on personal holding companies.*—For surtax on personal holding companies, see section 351.
(g) *Improper accumulation of surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

ART. 14-1. *Surtax on undistributed profits of corporations.*—In general, the Act imposes a surtax on the net income of corporations in an amount measured by the undistributed net income. The rates of surtax are graduated in brackets, the lowest rate being 7 percent of that portion of the undistributed net income not in excess of 10 percent of the adjusted net income and the highest rate being 27 percent of that portion of the undistributed net income which is in excess of 60 percent of the adjusted net income.

The adjusted net income is defined in section 14 (a) (1) as the net income (see section 21) minus the sum of (1) the normal tax imposed by section 13 and (2) the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities. In the case of a holding company affiliate, as defined in section 2 of the Banking Act of 1933, the amount to be deducted in determining the adjusted net income includes also the credit allowed under section 26 (d). In the case of a national mortgage association created under Title III of the National Housing Act, the amount to be deducted also includes the amount allowed as a credit under section 26 (e).

The undistributed net income is defined in section 14 (a) (2) as the adjusted net income minus the sum of (*a*) the dividends paid credit provided in section 27 (see articles 27 (a)-1 to 27 (h)-1, inclusive), and (*b*) the credit provided in section 26 (c), relating to contracts restricting the payment of dividends (see article 26-2).

Every corporation is subject to the surtax imposed by section 14 (b) except corporations expressly exempt from taxation under Title I (see section 101) and those corporations enumerated in section 14 (d).

A domestic corporation is not subject to the surtax on undistributed profits if for any portion of its taxable year—

(1) it is in bankruptcy under the laws of the United States; or

(2) it is insolvent and in receivership in any court of the United States or any State, Territory, or the District of Columbia.

Generally, in the case of proceedings for the relief of debtors under section 77 or 77B of the Bankruptcy Act of 1898, as amended, if the debtor corporation has pending a debtor's petition or answer which has been approved by the court finally determined to have jurisdiction thereof, it is in bankruptcy under the laws of the United States. In such case no exemption from the surtax on undistributed profits is allowed—

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

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

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

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

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

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

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

Any corporation claiming an exemption from surtax under section 14 (d) shall file as a part of its return for each taxable year for which the exemption is claimed a statement under oath of all facts pertinent to its claim.

ART. 14-2. *Method of computation of surtax—Example.*—The application of the provisions of section 14 (b) to corporations having an adjusted net income of not less than $50,000 may be illustrated generally by the following example:

Example.—The A Company, a domestic corporation, has for the calendar year 1936 a net income of $500,000, including interest on United States obligations in the amount of $25,000 and dividends amounting to $50,000 from domestic corporations subject to taxation under Title I. The normal tax of the A Company (not a mutual investment company) computed under section 13 is $63,715. Its dividends paid credit computed under section 27 (see articles 27 (a)-1 to 27 (h)-1, inclusive) amounts to $100,000, and its credit under section 26 (c) (see article 26-2) relating to contracts restricting the payment of dividends amounts to $80,000. The surtax for the calendar year 1936 is $36,487.73, computed as follows:

Net income		$500,000
Minus:		
(1) Normal tax under section 13	$63,715	
(2) Credit under section 26 (a) for interest on United States obligations	25,000	
		88,715
Adjusted net income as defined in section 14 (a) (1)		411,285
Minus:		
(1) Dividends paid credit under section 27	$100,000	
(2) Credit relating to contractual restrictions under section 26 (c)	80,000	
		180,000
Undistributed net income as defined in section 14 (a) (2)		231,285

The brackets into which the undistributed net income is divided, the amount of the undistributed net income in each bracket, the rate of surtax applicable thereto, the surtax at such rate, and the total surtax, are as follows:

Bracket	Amount of undistributed net income	Rate of tax	Sur tax
		Percent	
First, portion of undistributed net income not in excess of 10 percent of adjusted net income (10 percent of $411,285)	$41,128.50	7	$2,879.00
Second, portion of undistributed net income in excess of 10 percent of adjusted net income and not in excess of 20 percent of adjusted net income (10 percent of $411,285)	41,128.50	12	4,935.42
Third, portion of undistributed net income in excess of 20 percent of adjusted net income and not in excess of 40 percent of adjusted net income (20 percent of $411,285)	82,257.00	17	13,983.69
Fourth, portion of undistributed net income in excess of 40 percent of adjusted net income and not in excess of 60 percent of adjusted net income ($231,285 less $164,514, the sum of $41,128.50 plus $41,128.50 plus $82,257)	66,771.00	22	14,689.62
Total	231,285.00		36,487.73

ART. 14-3. *Specific credit if adjusted net income is less than $50,000.*—Section 14 (c) provides for a specific credit in the case of a corporation which has an adjusted net income of less than $50,000. This specific credit is an amount equal to the excess of $5,000 or the total undistributed net income, whichever is less, over 10 percent of the adjusted net income, and is to be deducted from the undistributed net income before computing the surtax. After deducting the specific credit from the undistributed net income a surtax is computed on the remainder. The computation is made first according to the brackets as set forth in section 14 (b). Then there is added 7 percent of the amount of the specific credit. The sum is the total surtax on the corporation's net income.

The application of the specific credit may be illustrated by the following examples:

Example (1).—The A Company has an adjusted net income for the calendar year 1936 of $1,000. Its undistributed net income likewise is $1,000. Giving effect to the specific credit, the surtax payable is $70, computed as follows:

Adjusted net income	$1,000
Undistributed net income	1,000
Computation of specific credit:	
Undistributed net income, or $5,000, whichever is less	1,000
Less 10 percent of adjusted net income	100
Specific credit under section 14 (c) (1)	900
Computation of the surtax:	
Undistributed net income	1,000
Less specific credit	900
Remainder subject to surtax under section 14 (b)	100
Surtax on remainder (7 percent of $100)	7
Plus 7 percent of amount of specific credit (7 percent of $900)	63
Total surtax computed under section 14 (c) (2)	70

In those cases in which the undistributed net income does not exceed $5,000, the result produced by application of the statutory method of computation illustrated by this example is obtainable by computing the surtax directly as 7 percent on the whole of the undistributed net income.

Example (2).—The B Company has an adjusted net income for the calendar year 1936 of $25,000. It pays no dividends during its taxable year and is allowed no credit under section 26 (c). It has, consequently, an undistributed net income of $25,000. Giving effect to the specific credit, the surtax payable is $4,625, computed as follows:

Adjusted net income	$25,000
Undistributed net income	25,000
Computation of specific credit:	
Undistributed net income, or $5,000, whichever is less	5,000
Less 10 percent of adjusted net income	2,500
Specific credit under section 14 (c) (1)	2,500

Computation of the surtax:	
Undistributed net income	$25,000
Less specific credit	2,500
Remainder subject to surtax under section 14 (b)	22,500
Surtax on $22,500	4,450
Plus 7 percent of amount of specific credit (7 percent of $2,500)	175
Total surtax computed under section 14 (c) (2)	4,625

Example (3).—The C Company has an adjusted net income for the calendar year 1936 of $49,900. It pays no dividends during its taxable year, and is entitled to no credits, other than the specific credit, so that it has for the taxable year an undistributed net income of an equal amount. Giving effect to the specific credit, the surtax payable is $10,227.50, computed as follows:

Adjusted net income	$49,900.00
Undistributed net income	49,900.00
Computation of specific credit:	
Undistributed net income, or $5,000, which ever is less	5,000.00
Less 10 percent of adjusted net income	4,990.00
Specific credit under section 14 (c) (1)	10.00
Computation of the surtax:	
Undistributed net income	49,900.00
Less specific credit	10.00
Remainder subject to surtax under section 14 (b)	49,890.00
Surtax on $49,890	10,226.80
Plus 7 percent of amount of specific credit (7 percent of $10)	.70
Total surtax computed under section 14 (c) (2)	10,227.50

CHAPTER III

Gross income—Net income

Part II—Computation of Net Income

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

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

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

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

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

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

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

The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. (See sections 23, 24, 102, 118, 121, 203, 204, 207, 232, and 351.)

SEC. 22. *Gross income*.—

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

ART. 22 (a)-1.—*What included in gross income*.—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211-238 and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property. As to dividends, whether in cash or in property, see section 115.

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see article 22 (a)-8.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example.—A taxpayer in 1931 purchased 500 shares of common stock at $125 a share, and in 1936, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. Instead of subscribing to the additional shares, A sold the rights at $4 each. The profit is computed as follows:

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

500 (shares) × $120 = $60,000, market value of old stock

500 (rights) × $3 = $1,500, market value of rights

$\frac{60,000}{61,500}$ of $62,500 = $60,975.61, cost of old stock apportioned to such stock after issuance of rights

$\frac{1,500}{61,500}$ of $62,500 = $1,524.39, cost of old stock apportioned to rights

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

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

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

Example.—A taxpayer in 1933 purchased 500 shares of common stock at $125 a share, and in 1936, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows.

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

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

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

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

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

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

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

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

ART. 22 (a)-10. *Sale of good will.*—Gain or loss from a sale of good will results only when the business, or a part of it, to which the good will attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including good will. (See articles 111-1, 113 (a) (14)-1, 113 (b)-1, and 113 (b)-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.

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

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

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

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

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

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

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

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

ART. 22 (a)-14. *Cancellation of indebtedness.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)-18.) 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. Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors, if immediately thereafter the taxpayer's liabilities exceed the value of his assets.

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

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

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

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

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

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

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

yet deducted) is a deductible expense for the taxable year. (c) If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

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

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

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

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

[SEC. 22. *Gross Income.*]

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

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

[Sec. 22. *Gross Income.*]

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

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

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

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

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

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

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

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

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

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

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

ART. 22 (b) (2)-2. *Annuities*.—Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, 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. If an annuity is payable in annual installments, there shall be included in gross income only such portion of the amounts received in any taxable year as is equal to 3 percent of the aggregate premiums or consideration paid for such annuity, whether or not paid during such year. If an annuity is payable in two or more installments over each 12-month period, such portion of each installment shall be taxable as is equal to 3 percent of the aggregate premiums or consideration paid for such annuity, whether or not paid during the taxable year, divided by the number of installments payable during such year. As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. The provisions of this article may be illustrated by the following examples:

Example (1).—A bought in 1933, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1936 he would be required to include in gross income $1,500 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 November 1, 1936, paying $96,000 as consideration therefor. The annuity amounts to $12,000 a year, payable in monthly installments of $1,000, and on December 1, 1936, A received the first installment. A shall include in his gross income for the calendar year 1936 the sum of $240, being 3 percent of $96,000 (the consideration paid), divided by 12 (the number of installments payable over a period of 12 months).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Earned income from sources without the United States;
Salaries of certain Territorial employees;
The income of foreign governments;
Income of States, municipalities, and other political subdivisions;
Receipts of shipowners' mutual protection and indemnity associatitons;
Dividends from China Trade Act corporations;
Compensation of employees of foreign governments.

[SEC. 22. *Gross Income.*]
(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

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

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

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

(2) It must clearly reflect the income.

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

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

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

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

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

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

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

(3) Omitting portions of the stock on hand.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

less

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

bears to (a).

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

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

[SEC. 22. *Gross Income.*]

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

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

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

CHAPTER IV

Deductions From Gross Income

SEC. 23. *Deductions From Gross Income.*—In computing net income there shall be allowed as deductions:

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

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

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

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

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

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

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

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

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

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

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

ART. 23 (a)–5. *Professional expenses.*—A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the cost of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts currently expended for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted. As to items not deductible, see section 24.

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

This test and its practical application may be further stated and illustrated as follows:

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

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

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

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

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

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

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

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

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

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

ART. 23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, first Liberty loan 3½ percent bonds, or (in case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax, is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (*a*) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by Title I of the Act, or (*b*) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes imposed by Title I of the Act, is deductible in accordance with the general rule.

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

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

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(c) *Taxes generally.*—Taxes paid or accrued within the taxable year, except—

(1) Federal income, war-profits, and excess-profits taxes (other than the excess-profits tax imposed by section 106 of the Revenue Act of 1935);
(2) income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States; but this deduction shall be allowed in the case of a taxpayer who does not signify in his return his desire to have to any extent the benefits of section 131 (relating to credit for taxes of foreign countries and possessions of the United States);
(3) estate, inheritance, legacy, succession, and gift taxes; and
(4) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

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

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

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

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(d) *Taxes of shareholder paid by corporation.*—The deduction for taxes allowed by subsection (c) shall be allowed to a corporation in the case of taxes imposed upon a shareholder of the corporation upon his interest as shareholder which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

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

[Sec. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(e) *Losses by individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

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

Art. 23. (e)-1. *Losses by individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, or (*c*) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (*d*) if not prohibited or limited by any of the following sections of the Act: Section 23 (g), relating to wagering losses; section 24 (a) (6), relating to losses from sales or exchanges of property between members of a family or between a corporation and its shareholders; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 117, relating to limitation on losses recognized by section 112 upon the sale or exchange of capital assets; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of United States; and section 252, relating to citizens of possessions of United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

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

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

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

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

Example (1).—Residential property was purchased by a taxpayer in 1926 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, 1933. From that date to January 1, 1936, 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, 1933, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1933. The property was sold on January 1, 1936, 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 1926	$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, 1933	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 1926	$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $10,000, cost of building)	1,500
	18,500
Selling price of property	16,000
Loss computed as provided in section 111	2,500
Deductible loss, except as limited by section 117	2,500

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

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

Art. 23 (e)-3. *Loss of useful value.*—When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and articles 113 (a) (14)-1, 113 (b)-1, and 113 (b)-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 or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

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

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

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

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

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

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(f) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

ART. 23 (f)-1. *Losses by corporations.*—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited by sections 23 (g), 24 (a) (6), 112, 117, 118, and 251. The provisions of articles 23 (e)-1, 23 (e)-2, 23 (e)-3, 23 (e)-4, 23 (e)-5, and 23 (h)-1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(g) *Wagering losses.*—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.
(h) *Basis for determining loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

ART. 23 (h)-1. *Basis for determining loss.*—The basis for determining the amount of the deduction for losses 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).)

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(i) *Loss on wash sales of stock or securities.*—For disallowance of loss deduction in the case of sales of stock or securities where within thirty days before or after the date of the sale the taxpayer has acquired substantially identical property, see section 118.
(j) *Capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).
(k) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

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

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

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

Taxpayers were given an option for 1921 to select either of the methods mentioned for treating such debts. (See article 151 Regulations 62.) The method used in the return for 1921 must be used in returns for subsequent years and in returns under the Revenue Act of 1936 unless permission is granted by the Commissioner to change to the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also article 23 (k)-5.)

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

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

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

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

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

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

ART. 23 (k)-4. *Worthless bonds and similar obligations.*—Bonds, if ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year.

A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. If a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and so demonstrates to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations.

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

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

[Sec. 23. *Deductions from Gross Income.*]

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

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

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

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

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

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

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

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

Example.—An asset was purchased January 1, 1931, 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 1931 to 1935 as followed:

1931	$1,000.00
1932	---------
1933	2,000.00
1934	2,000.00
1935	---------
Total amount allowed	5,000.00

The correct amended reserve as of December 31, 1935, is computed as follows:

December 31—	
1931	$1,000.00
1932	1,000.00
1933	2,000.00
1934	2,000.00
1935	666.67
Reserve December 31, 1935	6,666.67

Depreciation for 1936 and subsequent taxable years is $666.67, computed as follows:

Cost	$10,000.00
Reserve as of December 31, 1935	6,666.67
Unrecovered cost	3,333.33
Depreciation allowable for 1936 and each subsequent taxable year (6⅔ percent of $10,000)	666.67

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

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

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

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

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

[SEC. 23. *Deductions from Gross Income.*]
[In computing net income there shall be allowed as deductions:]
(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Subject to the qualification specified in the last sentence of this paragraph, a taxpayer making his first return under Title I of the Act (for a taxable year beginning after December 31, 1935) in respect of a property must state as to each such property whether he elects to have the depletion allowance for each such property for the taxable year computed with or without reference to percentage depletion. For the purpose of this article the taxpayer's first return under Title I of the Act in respect of a property is the return made under that title for his first taxable year (beginning after December 31, 1935) for which he has any item of income or deduction with respect to such property. An election once exercised under section 114 (b) (4) and this article can not thereafter be changed by the taxpayer, and the depletion allowance in respect of each such property will for all succeeding taxable years be computed in accordance with the election so made. If the taxpayer fails to make such statement in the return in which the election should be so indicated, the depletion allowance for the year for which an election must be first exercised and for all succeeding taxable years will be computed without reference to percentage depletion. The method, determined under section 114 (b) (4) and this article, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section. The right of election specified in this paragraph is subject to the qualification that section 114 (b) (4) shall, for the purpose of determining whether the method of computing the depletion allowance follows the property, be considered a continuation of section 114 (b) (4) of the Revenue Act of 1934, and as giving no new election in cases where such section would if applied, give no new election.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the lessors of sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year beginning after December 31, 1935, for which he first makes return in respect of the property (and for subsequent taxable years in case an election to have depletion computed on a percentage basis has been exercised in the proper return) 23 percent, 15 percent, and 5 percent, respectively, of the amount thereof; but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

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

If the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it can not 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 articles 23 (m)-2, 23 (m)-3, 23 (m)-4, or 23 (m)-5; or the amounts of the depletion and depreciation so computed shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deductions as may thereafter be allowable under section 114 (b) (2), (3), or (4) and articles 23 (m)-3, 23 (m)-4, or 23 (m)-5.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(5) A property map showing the location of the property and of the producing and abandoned wells, dry

holes, and proven oil and gas lands (the map should show depth, initial production, and date of completion of each well, to the extent that such data are available);

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*c*) Nonoptional items distinguished:

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

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

(*d*) This article does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)-16 of Regulations 86 is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1936, or after December 31, 1935, 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, 1935, must made 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, 1935, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (1) in his return for the first taxable year ending after December 31, 1924, in which optional expenditures of the respective types are or were made, or (2) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4025. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1935, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*e*) Record of timber cut;

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

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

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

(*i*) Unit production costs; and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[SEC. 23. *Deductions from Gross Income.*]

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

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

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

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

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

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

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

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

ART. 23 (o)-1. *Contributions or gifts by individuals.*—In connection with claims for deductions under section 23 (o), there shall be stated on returns of income the name and address of each organization to which a contribution or gift was made and the approximate date and the amount 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 the name and address of the contributor or donor, the amount of the contribution or gift and the date it was made, and by such other information as the Commissioner may deem necessary. If the contribution or gift is other than money, the basis for calculation of the amount thereof shall be the fair market value of the property at the time of the contribution or gift. No part of the contributions or gifts made by a partnership may be claimed as a deduction in the personal return of a partner. As to deduction of contributions or gifts by partnerships, see section 183. 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. This article does not apply to gifts by estates and trusts (see section 162). For contributions or gifts by corporations see article 23 (q)-1.

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

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

[SEC. 23. *Deductions from Gross Income.*]

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

(p) *Pension trusts.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees (if such trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made. Any deduction allowable under section 23 (q) of the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 which under such section was apportioned to any taxable year beginning after December 31, 1935, shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.

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

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

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

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

In no case will any amount be allowed as a deduction under this article which was allowable as a deduction from gross income for any prior year. Devices of whatever nature for withdrawing profits or paying salaries to officers are not pension trusts within the meaning of the Act.

A taxpayer claiming the benefit of the deduction allowable by section 23 (p) must show himself entitled to such deduction. If a deduction from gross income is claimed on account of payments to an employees' pension trust, the following described data shall be filed with the return:

1. A statement describing the pension trust plan, including the basis and method of its operation, together with a copy of the trust indenture, with any amendments thereto, and other documents constituting a part of the plan.

2. If all employees are not included as beneficiaries of the pension trust, a statement showing what classes of employees are excluded, and the general nature of their respective employment and duties, together with the reason why all employees are not covered by the pension trust plan.

3. A statement showing the actuarial computation upon which the deduction is based.

4. A statement of the receipts and disbursements of the trust.

5. A schedule showing the application of actuarially computed "reserve factors" to the pay roll data properly classified for the purpose of computing the reserve liability of the pension fund as of the end of the taxable year.

6. A schedule showing the application of actuarially computed "current liability factors" to the pay roll data properly classified for the purpose of computing the liability of the pension fund as of the end of the taxable year.

7. A schedule showing the computation of the pension liability for all employees retired prior to the taxable year.

8. A schedule showing the computation of the liability for employees retired during the taxable year.

9. A schedule showing the receipts and disbursements of the pension fund during each month of the taxable year, and the total amount of the fund as of the beginning and end of the taxable year.

If the valuation factors are changed at any time, either because of a change in the pension plan or because of a change in the assumptions upon which the valuation factors are based, the data indicated under 5, 6, and 7 above, should be submitted showing the new valuation factors applied to the pay roll data classified as of the end of the preceding taxable year, and also as of the end of the current taxable year.

If the pension plan does not contemplate the payment to the trust in advance of the time when pensions are granted, of amounts to provide for future pension payments, the data described under 5 and 6 above need not be furnished.

In cases where the annuity plan is underwritten by an insurance company, the taxpayer should show the amount of any refunds made to him by the carrier under the terms of his annuity contract. If such refunds were applied by the insurance company to reduce subsequent premiums or to reduce the accrued liability of the annuity plan, or in any other manner except a cash refund, the taxpayer should submit full information in regard thereto.

The right to a deduction under section 23 (p) will be recognized in cases where the pension trust may not be perpetual, provided the trust is of such a character as to evidence good faith on the part of the employer actually to pay the amounts placed in trust for employees' pension purposes. However, should any portion of the funds of a pension trust revert to the possession, ownership, or control of the employer by reason of the termination of the trust or otherwise, such amount (except to the extent that it represents a payment to the pension trust made by the employer in accordance with the pension plan and pursuant to paragraph (*a*) or (*b*) of this article, and not theretofore allowed as a deduction to the employer) shall be returned as income by the employer for the taxable year in which it so reverts, unless prior to the close of such year it shall again be placed in trust for the benefit of employees under provisions satisfactory to the Commissioner.

A pension trust maintained by affiliated corporations for the exclusive benefit of their employees is within the scope of sections 23 (p) and 165.

Example—Accruals in advance of pensions granted.—In 1936 the M Company adopted a reasonable pension plan and established a pension trust which was exempt from tax under section 165. During the year and upon the basis of an actuarial computation the company paid $8,950,000 to the trust. At the time of the payment and in accordance with the pension plan of the company, the pension liability applicable to the years prior to 1936, in respect of employees then on the retired roll, for pensions to be paid in the future, was $2,000,000; the pension liability applicable to the years prior to 1936, in respect of employees on the active roll, for pensions to be paid in the future, was $6,500,000; the payment required to cover the pension liability applicable to the taxable year 1936 for pensions to be paid in the future, was $450,000. The amount paid to retired employees of the M Company by the pension trust as pensions during 1936 was $360,000.

The deduction for 1936 is computed as follows:

(*a*) Entire amount paid to pension trust representing the pension liability applicable to 1936 for pensions to be paid in the future	$450,000
(*b*) One-tenth of $8,500,000, amount transferred to pension trust to cover the pension liability applicable to the years prior to 1936, in respect of employees on either the retired roll or the active roll, for pensions to be paid in the future	850,000
Total deduction	1,300,000

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

Example—Accruals on basis of pensions granted.—In 1936 the N Company adopted a reasonable pension plan and established a pension trust which was exempt from tax under section 165. During the year and upon the basis of an actuarial computation the company paid $2,300,000 to the trust. At the time of the payment the present value of the expected future payments in respect of pensions granted to employees retired prior to 1936 was $2,000,000; the present value of the expected future payments in respect of pensions granted to employees retired during 1936 was $300,000. The amount paid to retired employees of the N Company by the pension trust as pensions during 1936 was $360,000.

The deduction for 1936 is computed as follows:

(*a*) Entire amount paid to the penison trust representing the present value of the expected future payments in respect of pensions granted to employees retired during 1936	$300,000
(*b*) One-tenth of $2,000,000, the amount transferred to the pension trust to cover the present value of the expected future payments in respect of pensions granted to employees retired prior to 1936	200,000
Total deduction	500,000

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

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

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

ART. 23 (q)-1. *Contributions or gifts by corporations.*—A corporation is entitled to deduct from gross income for a taxable year beginning after December 31, 1935, contributions or gifts to organizations referred to in section 23 (q), whether or not such contributions or gifts constitute business expenses, but only to the extent provided in that section.

Corporations may deduct, for a taxable year beginning after December 31, 1935, to the extent provided by section 23 (q), contributions or gifts to organizations referred to in that section, only for the taxable year in which they are actually paid, regardless of when pledged and regardless of whether the books and records of the corporation are kept on the cash receipts and disbursements basis or the accrual basis.

The provisions of the first paragraph of article 23 (o)-1, relating to (1) the statement in returns of the name and address of each organization to which a contribution or gift was made and the approximate date and the amount 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).

Donations to organizations other than those referred to 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 the reasonable expectation that the holding of such convention will augment its income through a greater number of people using the cars. 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.

SEC. 24. *Items not Deductible.*—

(a) *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

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

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

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

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

(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

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

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

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

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

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

ART. 24-4. *Amounts allocable to exempt income, other than interest*—(a) *Class of exempt income.*—As used in this article, the term "class of exempt income" means any class of income, other than interest (whether or not any amount of income of that class or classes is received or accrued), wholly exempt from the taxes imposed by Title I of the Act. Included are any item or class of income, other than interest, constitutionally exempt from the taxes imposed by Title I; any item or class, other than interest, excluded from gross income under any provision of section 22 or section 116 of the Act; and any item or class of income, other than interest, exempt under the provisions of any other law from the taxes imposed by Title I. Thus the income derived from the operation of a lease of State lands, constituting such an instrumentality of the State as to render the income constitutionally exempt from the tax, is a class of exempt income. The expenses or other items referable to the operation of such a lease are allocable to a class of exempt income, even though no income was received or accrued from such operations during the year.

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

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

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

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

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

ART. 24-5. *Losses from sales between members of family and between individuals and corporations.*—The provisions of section 24 (a) (6) may be illustrated generally by the following example:

Example.—During the calendar year 1936, A had losses from sales of shares of stock as follows:

Cost or other basis of shares sold	Selling price	Loss	Person to whom sold
$4,000	$3,900	$100	Grandfather of A.
4,000	3,800	200	Half-brother of A.
4,000	3,700	300	Spouse of A.
4,000	3,600	400	Granddaughter of A.
4,000	3,500	500	The M corporation, 55 percent in value of the outstanding stock of which was owned by A.
4,000	3,400	600	The O corporation, 100 percent in value of the outstanding stock of which was owned by the P corporation, 51 percent in value of the outstanding stock of the P corporation being owned by the grandson of A.

Under section 24 (a) (6) none of the above-described losses of A are deductible from his gross income.

ART. 24-6. *Life or terminable interests.*—Amount paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time. (See section 113 (a) (5).)

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

CHAPTER V

CREDITS AGAINST INCOME

SEC. 25. *Credits of Individual Against Net Income.*—

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

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

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

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

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

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

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

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

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

(1) *Personal exemption.*—In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them.

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

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

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

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

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

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

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

Example 1.—An individual received income from interest on bonds during the calendar year 1936 amounting to $6,000. His allowable deductions under section 23 for that year amounted to $2,000. He is entitled to an earned income credit of $300, computed as follows:

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

Example 2.—An individual received a salary of $20,000 as a traveling salesman for the calendar year 1936. 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 1936 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 limitations in section 25 (a) (4) (A)	$10,000
Earned income as limited by section 25 (a) (4) (A) (20 percent of $35,000)	7,000
Earned income credit allowable (10 percent of $7,000)	700

ART. 25-3. *Amount of personal exemption allowable.*—A single person is entitled to a personal exemption of $1,000 and the head of a family or a married person living with husband or wife to $2,500, regardless of the amount of the net income. A husband and wife living together have but one personal exemption, which is $2,500. If they make

separate returns, each may claim one-half of the personal exemption, or such exemption may, in accordance with an agreement entered into by them, be taken by either or divided between them in any proportion.

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

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

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

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

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

Example (1).—A, who had been single during the preceding months of 1936, married B on July 20 and lived with her during the remainder of the year. If a joint return is made by A and B on the calendar year basis for 1936, the personal exemption will be $2,208.33; that is, 7/12 of $1,000 for A while single, plus 7/12 of $1,000 for B while single, plus 5/12 of $2,500 for the period during which they were married. If separate returns are made by A and B on the calendar year basis for 1936, each may claim a personal exemption of $1,104.17; that is, 7/12 of $1,000, plus 1/2 of 5/12 of $2,500. In the latter case, however, the joint exemption of 5/12 of $2,500 may by agreement be taken either by A or B or divided between them in any proportion.

Example (2).—A and B, who were heads of families during the first six months of 1936, were married on July 1, 1936, 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 1936, the personal exemption will be $3,750; that is, 1/2 of $2,500 for A while the head of a family, plus 1/2 of $2,500 for B while the head of a family, plus 1/2 of $2,500 for the period during which they were married and living together. If separate returns are made by A and B on the calendar year basis for 1936, each may claim a personal exemption of $1,875; that is, 1/2 of $2,500, plus 1/2 of 1/2 of $2,500. In the latter case, however, the joint exemption of 1/2 of $2,500 may by agreement be taken either by A or B or divided between them in any proportion.

Example (3).—A and B were married and living together until November 30, 1936, when B, the wife, died. They had no dependents. The executor or administrator in making a return for B may claim a personal exemption of $1,229.16; that is, 1/2 of 11/12 of $2,500, or $1,145.83, for the period from the beginning of the taxable year to the date of the decedent's death, plus 1/12 of $1,000, or $83.33, for the period from the date of the decedent's death to the close of the taxable year. If A, the surviving spouse, makes a return for 1936 on the calendar year basis, he may claim a personal exemption of $1,229.16; that is, 1/2 of 11/12 of $2,500, or $1,145.83, plus 1/12 of $1,000, or $83.33. However, the combined personal exemption of A and B for the period during which they were married and living together, that is, 11/12 of $2,500, or $2,291.67, may by agreement be taken either by A, or by B's executor or administrator in behalf of B, or divided between them in any proportion.

Example (4).—A furnished the chief support of a child under 18 years of age until the death of the child on June 20, 1936. If A makes a return on the calendar year basis for 1936, he is entitled, in addition to the personal exemption allowed under section 25 (b) (1), to a credit for dependents in the amount of $200; that is, 6/12 of $400.

Example (5).—A and B were married and living together until June 30, 1936, when A, the husband, died. Prior to the date of death, A was the chief support of a child 10 years of age. B, the surviving spouse, was the chief support of the child during the remainder of the year. If B makes a return for 1936 on the calendar year basis, she is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $200; that is, 6/12 of $400. The executor or administrator in making a return for A is entitled, in addition to a personal exemption, to a credit for dependents in the amount of $200; that is, 6/12 of $400.

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

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

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

(c) *Contracts restricting payment of dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double credit not allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

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

(e) *National mortgage associations.*—In the case of a national mortgage association created under Title III of the National Housing Act, the amount of the earnings or profits which the Federal Housing Administrator certifies to the Commissioner has been devoted by such association during the taxable year to the acquisition of such reserves as the Administrator may require under the provisions of section 303 of that Act.

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

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form, as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 20 (c)(1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

The computation of the credit allowable under section 26 (c)(1) may be illustrated by the following examples:

Example (1).—For the calendar year 1936 the A Corporation (which was organized in 1918) has a net income (on the accrual basis) of $200,000, a normal tax liability of $28,840, and an adjusted net income of $171,160. At the beginning of the taxable year is had $50,000 of accumulated earnings and profits. Its earnings and profits of the taxable year before deducting Federal income taxes amount to $210,000. The corporation has second mortgage 6 percent bonds outstanding at the close of the year, issued prior to January 1, 1936, in the amount of $1,000,000. An amount of the earnings and profits sufficient to retire 10 percent of such bonds must, by the provisions of the underlying mortgage, be set aside annually before any dividends can be paid on its stock. The credit allowable under section 26 (c)(1) is $40,000, computed as follows:

Adjusted net income		$171,160
Aggregate of amounts which can be distributed:		
Earnings and profits of the taxable year before deducting Federal income taxes	$210,000	
Less normal tax	28,840	
	181,160	
Plus earnings and profits at beginning of taxable year accumulated after February 28, 1913	50,000	
	231,160	
Less amount required for retirement of bonds	100,000	
		131,160
Credit allowable		40,000

Example (2).—Under the terms of a contract entered into prior to January 1, 1936, Corporation B obtained a loan of $300,000. The contract provided that as long as the debt remains unpaid not more than 50 percent of the annual earnings shall be used for the payment of dividends. Corporation B has an adjusted net income (on the accrual basis) of $162,660 and a normal tax liability of $27,340. The current earnings and profits amount to $140,000 before deducting Federal income taxes and in addition thereto the corporation had at the beginning of its taxable year $40,000 representing earnings and profits accumulated after February 28, 1913. The credit allowable under section 26 (c) (1) is $66,330, computed as follows:

Adjusted net income		$162,660
Aggregate of amounts which can be distributed:		
Current earnings and profits	$140,000	
Less normal tax	27,340	
Current earnings and profits available	112,660	
Plus earnings and profits at beginning of taxable year accumulated after February 28, 1913	40,000	
Total	152,660	
Less amount restricted: 50 percent of current earnings, i. e., 50 percent of $112,660	56,330	
		96,330
Credit allowable		66,330

(c) *Disposition of profits of taxable year*.—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractural provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income", "net earnings", or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is 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. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

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

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

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

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

No credit is allowable either for the amount of readily marketable assets acquired and on hand at the beginning of the first taxable year subject to the Revenue Act of 1936 or for an amount of readily marketable assets in excess of what is required, by such section 5144, to be acquired by such affiliate.

Every taxpayer claiming and making a deduction for the credit provided for in section 26 (d) shall attach to its return a supplementary statement, in duplicate, setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see subsections (b) and (c) of section 5144 of the Revised Statutes (paragraph 56 of the Appendix to these regulations).

SEC. 27. *Corporation Credit for Dividends Paid.*—

(a) *Dividends paid credit in general.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

ART. 27 (a)–1. *Dividends paid credit in general.*—(a) *Allowance.*—The amount of the dividends paid credit provided by section 27 is the amount of the dividends paid during the taxable year, subject, however, to the qualifications, limitations, and exceptions prescribed in subsections (b) to (h), inclusive, of section 27. See also section 121 with respect to dividends paid on preferred stock owned by the United States or instrumentalities thereof.

(b) *When dividends are considered paid.*—A dividend will be considered as paid when it is received by the shareholder. A dividends paid credit can not be allowed unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

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

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

If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the credit for a dividend paid will not be allowed 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.

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

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

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

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

(c) *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.

(d) *Records.*—Every corporation claiming a dividends paid credit shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such credit is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (*a*) a true copy of the dividend resolution; and (*b*) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (1) the medium of payment and (2), if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed, and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

[SEC. 27. *Corporation Credit for Dividends Paid.*]

(b) *Dividend carry-over.*—In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

ART. 27 (b)-1. *Dividend carry-over.*—A corporation is allowed under section 27 (b) to include in its dividends paid credit a dividend carry-over from certain preceding taxable years, in addition to the credit for dividends paid during the taxable year. If in the taxable year no dividends are actually paid or if in such year dividends actually paid are less in amount than the adjusted net income for such year, there shall be included as part of the dividends paid credit for such taxable year in the following order—

(1) the amount by which dividends which were actually paid during the second preceding taxable year exceeded the adjusted net income for such year, but only to the extent that the excess was not needed as part of the dividends paid credit for the first preceding taxable year (whether or not the part needed was actually included in the dividends paid credit of such first preceding taxable year); and

(2) the amount by which the dividends actually paid during the first preceding taxable year exceeded the adjusted net income for such year.

The Act prohibits any part of the dividend carry-over from consisting of dividends paid by the corporation during any taxable year or period beginning prior to January 1, 1936. The first taxable year or period for which a corporation may avail itself of the benefit of the dividend carry-over is its second taxable year or period beginning after December 31, 1935.

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

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

Example (1).—The N Corporation has an adjusted net income of $80,000 for the calendar year 1936, and during that year pays dividends aggregating $90,000. For the calendar year 1937 the corporation has an adjusted net income of $120,000 and during that year pays dividends in the amount of $50,000. The dividends paid credit for the calendar year 1937 is $60,000, computed as follows:

Dividends paid during 1936	$90,000
Adjusted net income for 1936	80,000
Excess of dividends paid during 1936 over adjusted net income for that year	10,000
Dividends paid during 1937	50,000
Plus excess of dividends paid during 1936 over adjusted net income for 1936	10,000
Dividends paid credit for 1937	60,000

Example (2).—The R Corporation has an adjusted net income of $60,000 for the calendar year 1936 and during that year pays dividends aggregating $75,000. For the calendar year 1937 the corporation has an adjusted net income of $100,000 and during that year pays dividends aggregating $90,000. During the calendar year 1938 the corporation pays dividends of $50,000, the adjusted net income for that year being $80,000. The dividends paid credit for the calendar year 1937 is $100,000, computed as follows:

Dividends paid during 1937	$90,000
Portion of $15,000, the excess of dividends paid during 1936 ($75,000) over adjusted net income for that year ($60,000) needed as a dividends paid credit for 1937	10,000
Dividends paid credit for 1937	100,000

The dividends paid credit for the calendar year 1938 is $55,000, computed as follows:

Dividends paid during 1938	$50,000
Plus:	
The excess of dividends paid during 1936 over adjusted net income for that year ($75,000—$60,000, or $15,000), to the extent not needed as dividends paid credit for 1937 ($15,000—$10,000)	5,000
Excess of dividends paid during 1937 over adjusted net income for that year	None
Dividends paid credit for 1938	55,000

As applied to this example, the Act provides for a 2-year dividend carry-over in computing the dividends paid credit for 1938, since the excess ($15,000) of the dividends paid during 1936 over the adjusted net income for that year is allowed as part of the dividends paid credit for 1937 and 1938, $10,000 of such excess being applicable to 1937 and the remaining $5,000 to 1938. Of the $15,000 excess, the entire amount of $10,000 (the difference between the adjusted net income of $100,000 and the dividends of $90,000 paid during 1937) must be applied, if at all, as part of the dividends paid credit for 1937.

[SEC. 27. *Corporation Credit for Dividends Paid.*]

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

ART. 27 (c)-1. *Dividends in kind.*—Section 27 (c) 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 dividends paid 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 dividends paid credit to which the corporation is entitled with respect thereto can not exceed the lesser of the two following amounts determined as of the time of payment:

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

(2) The fair market value of such property.

As used in this article the term "property" includes shares of capital stock of the corporation making the dividend distribution if such shares of stock are held by it as an investment. Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment. The term "property" also includes obligations upon which the corporation making the distribution is liable as a guarantor, indorser, or surety.

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

Example.—The S. Corporation, in 1930, purchased stock of the Y Corporation for $100,000. In 1936 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 Y Corporation accumulated before March 1, 1913. In 1936 the corporation used such stock for the payment of a dividend. The dividends paid credit for 1936 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
Dividends paid credit for 1936	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 dividends paid credit for 1936 with respect to such stock.

[SEC. 27. *Corporation Credit for Dividends Paid.*]

(d) *Dividends in obligations of the corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

ART. 27 (d)-1. *Dividends in obligations of the corporation.*—Section 27 (d) is concerned solely with the amount of dividends paid credit allowable 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 dividends paid credit 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 the dividends paid credit as of the date of payment is limited to the fair market value of the corporate obligations distributed, the corporation becomes entitled to an additional dividends paid 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 dividends paid credit is in excess of the price at which such obligations are redeemed over their fair market value at the time of the distribution, subject to the restriction that such excess be diminished by any amounts which were allowable as deductions for amortized bond discount or bond issue commissions and expenses allocable to the obligations redeemed in computing the net income of the corporation for any taxable year. A corporation is entitled to such additional dividends paid credit regardless of the identity of the holders of the obligations at the time of their redemption.

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

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

Example.—The X Corporation 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 is the fair market value of the bonds at the time of the dividend payment ($75,000), since such fair market value is lower than the face value ($100,000) of the obligations.

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 dividends paid credit with respect to the bond redemption for the taxable year 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 taxable year in which redemption occurs	10,000

[SEC. 27. *Corporation Credit for Dividends Paid.*]

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

ART. 27 (e)-1. *Taxable stock dividends.*—The dividends paid credit provided by section 27 with respect to distributions in stock dividends or stock rights is limited by section 27 (e) to distributions which are taxable dividends in the hands of shareholders under section 115 (f) and article 115-3. Such credit, however, is limited in amount to the fair market value of such stock or stock rights at the time of the payment of the dividend. As to a distribution by a corporation of its own capital stock held as an investment, see article 27 (c)-1.

[SEC. 27. *Corporation Credit for Dividends Paid.*]

(f) *Distributions in liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

ART. 2 (f)-1. *Dividends paid credit for distributions in liquidation.*—(a) *Distributions which diminish earnings or profits.*—To the general rule that the dividends paid credit is allowable only with respect to taxable dividends paid, section 27 (f) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Act, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Act as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

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

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

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

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Act, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Act as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Act. No dividends paid credit is allowable 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 a dividends paid credit is allowable (see paragraph (a) of this article) the amount of the credit is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example.—The Y Corporation 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, 1936, 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, 1936, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Act, such transaction being only a partial liquidation under section 115 (c). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is allowable as a dividends paid credit.

(c) *Credit in respect of earnings or profits transferred under certain tax-free transactions.*—If, as a result of one or more transactions described in section 112, a corporation's earnings or profits accumulated after February 28, 1913, and its undistributed earnings or profits of the taxable year, shall have become the earnings or profits of another corporation subject to distribution as dividends by such other corporation, any dividend paid by the transferee corporation during that portion of the transferor's taxable year subsequent to the consummation of such tax-free transaction may, subject to the provisions of section 115, be apportioned and allocated to the transferor as a distribution out of such earnings or profits of the transferor. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated. For the purposes of the dividends paid credit, any such distribution so allocated shall be treated as a dividend paid only in the computation of the 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 dividends paid credit based upon such apportionment and allocation will be allowed 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 keeps its books and 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 keeps its books and makes its returns on the calendar year basis, was completely liquidated on December 1, 1936. 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 1936 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, 1936, $25,000; September 15, 1936, $25,000; December 15, 1936, $25,000; and March 15, 1937, $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, 1937, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation's accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).

[SEC. 27. *Corporation credit for dividends paid.*]
(g) *Preferential dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

ART. 27 (g)-1. *Preferential distributions.*—Section 27 (g) imposes a limitation upon the general rule that a corporation is entitled to a dividends paid credit with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any dividends paid credit 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. The limitation imposed by the Act is unqualified and the existence of a preference is sufficient to prohibit allowance of the dividends paid credit 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 a dividends paid credit 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. The disallowance of the dividends paid credit, where any preference or inequality in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. The term "distribution," as used in this article, includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (f).

The application of the provisions of section 27 (g), relating to distributions which are preferential or unequal in amount, 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 returns on a calendar year basis. With the consent of all the shareholders, the M Corporation, on July 15, 1936, declared a dividend of $5 a share payable in cash on August 1, 1936, to A. On September 15, 1936, it declared a dividend of $5 a share payable in cash on October 1, 1936, to B, C, and D. No dividends paid credit for the taxable year 1936, is allowable to the M Corporation with respect to any part of the dividends paid on August 1, 1936, and October 1,1936.

Example (2).—The N Corporation 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 1936, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No dividends paid credit is allowable under section 27 (g) with respect to such distribution.

[SEC. 27. *Corporation Credit for Dividends Paid.*]
(h) *Nontaxable distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

ART. 27 (h)-1. *Nontaxable distributions.*—No dividends paid credit shall be allowed with respect to any part of the distribution by a corporation to its shareholders which is—

(*a*) not out of earnings or profits of the taxable year or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (see section 115), or, in the case of distributions in liquidation, not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under article 27 (f)-1;

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

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

The effect of subsections (g) and (h) of section 27 is that no dividends paid credit is allowed with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under Title I for the period in which the distribution is made, receives a taxable dividend as a result of the distribution.

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

Example (1).—A, B, C, and D are the shareholders of the Y Corporation, which makes its returns on the calendar year basis, D being an educational corporation, exempt from income tax under section 101. On July 15, 1936, the Y Corporation paid a dividend (within the meaning of section 115) in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The Y Corporation is entitled to a dividends paid credit in the amount of $1,000 with respect to the dividends paid on July 15.

Example (2).—If the facts in the preceding example are the same, except that A and B make their returns on the basis of the fiscal year ending July 31, the Y Corporation is entitled to a dividends paid credit in the amount of $1,000 with respect to the dividends paid on July 15.

CHAPTER VI

Credits Against Tax

Part III—Credits Against Tax

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

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

SEC. 33. *Credit for Overpayments.*—For credit against the tax of overpayments of taxes imposed by this title for other taxable years, see section 322.

CHAPTER VII

Accounting Periods and Methods

Part IV—Accounting Periods and Methods of Accounting

SEC. 41. *General Rule.*—The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

ART. 41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42-1 to 42-3.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See articles 42-2 and 42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see article 22 (c)-5.)

The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this article, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see articles (22 (c)-1 to 22 (c)-8); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see article 42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see articles 22 (a)-7 and 23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected.

Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in article 44-1, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

ART. 41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and article 54-1.) Among the essentials are following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22 (c) and articles 22 (c)-1 to 22 (c)-8;

(2) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

ART. 41-4. *Accounting period.*—The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. See article 46-1.

SEC. 42. *Period in Which Items of Gross Income Included.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

ART. 42-1. *When included in gross income.*—Except as otherwise provided in section 42 in the case of the death of a taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See articles 41-1 to 41-3.) If a taxpayer has died there shall also be included in computing net income for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, regardless of the fact that the decedent may have kept his books and made his returns on the basis of cash receipts and disbursements. If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See article 23 (k)-1.) Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or, for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

ART. 42-2. *Income not reduced to possession.*—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

ART. 42-3. *Examples of constructive receipt.*—If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. The amount of defaulted coupons is income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. If a dividend is declared payable on December 31 and the corporation intended to and did follow its practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been unqualifiedly made subject to the demand of the shareholders prior to January, when the checks were actually received. As to the distributive share of the profits of a partner in a partnership, see section 188. Interest credited on savings bank deposits, even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. If the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

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

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

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

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

ART. 42-5. *Subtraction for redemption of trading stamps.*—If a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing—

(*a*) The total issue of stamps during each year;

(*b*) The total stamps redeemed in each year; and

(*c*) The rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year, regardless of the year when such redeemed stamps were issued.

A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive, appropriate adjustment will be made.

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

ART. 43-1. *"Paid or incurred" and "paid or accrued."*—(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

(*b*) The provisions of paragraph (*a*) of this article in general are not applicable with respect to the taxable period during which the taxpayer dies. In such case there shall also be allowed as deductions and credits for such taxable period amounts accrued up to the date of his death if not otherwise allowable with respect to such period or a prior period, regardless of the fact that the decedent was required to keep his books and make his returns on the basis of cash receipts and disbursements.

ART. 43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

SEC. 44. *Installment Basis.*—

(a) *Dealers in personal property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized, or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

(c) *Change from accrual to installment basis.*—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his net income on the installment basis, then in computing his income for the year of change or any subsequent year, amounts actually received during any such year on account of sales or other dispositions of property made in any prior year shall not be excluded.

(d) *Gain or loss upon disposition of installment obligations.*—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment.

ART. 44-1. *Sale of personal property on installment plan.*—Dealers in personal property ordinarily sell either for cash or on the personal credit of the purchaser or on the installment plan. Dealers who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default—

(*a*) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(*b*) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(*c*) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(*d*) By conveyance to a trustee pending performance of the contract and subject to its provisions.

The general purpose and effect being the same in all of these cases, the same rule is uniformly applicable. The general rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total or gross profit (that is, sales less cost of goods sold) realized or to be realized when the property is paid for, bears to the total contract price. Thus the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment basis of returning income. But in the case of any taxpayer who, by an original return made prior to February 26, 1926, changed the method of reporting his net income for the taxable year 1924 or any prior taxable year to the installment basis, see section 705 of the Revenue Act of 1928. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued", as provided by sections 43 and 48. A dealer who desires to compute his income on the installment basis shall maintain books of account in such a manner as to enable an accurate computation to be made on such basis in accordance with the provisions of this article.

The income from a casual sale or other casual disposition of personal property (other than property of a kind which should properly be included in inventory) may be reported on the installment basis only if (1) the sale price exceeds $1,000 and (2) the initial payments do not exceed 30 percent of the selling price.

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property, the entire amount received in installment payments and retained by the vendor, less the sum of the profits previously returned as income and an amount representing proper allowance for damage and use, if any, will be income of the vendor for the year in which the property is repossessed, and the property repossessed must be carried on the books of the vendor at its original cost, less proper allowance for damage and use, if any.

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.

If an installment obligation is satisfied, or otherwise disposed of, gain or loss may result therefrom and must be determined in accordance with section 44 (d) and article 44-5.

ART. 44-2. *Sale of real property involving deferred payments.*—Under section 44 deferred-payment sales of real property include (*a*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (*b*) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to referred payments. Such sales, either under (*a*) or (*b*), fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in articles 44-1 and 44-3, and in this article. The term "initial payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "selling price." The term "initial payments" contemplates at least one other payment in addition to the initial payment. If the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.

ART. 44-3. *Sale of real property on installment plan.*—In transactions included in class (1) in article 44-2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If the vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession, of fixed improvements placed on the property by the purchaser. If the vendor has previously transferred title to the purchaser, and the purchaser defaults in any of his payments and the vendor reacquires the property, such reacquisition shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of reacquisition, measured by the difference between the fair market value of the property reacquired, including the fair market value of fixed improvements placed on the property by the purchaser, and the basis in the hands of the vendor of the obligations of the purchaser which were applied by the vendor to the purchase or bid price of the property. The basis in the hands of the vendor of the obligations of the purchaser so applied will be the excess of the face value of the obligations over an amount equal to the income which would be returnable were the obligations satisfied in full. The fair market value of the property reacquired shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of the fixed improvements placed on the property by the purchaser.

If the 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 sale will be treated as deferred-payment sales not on the installment plan.

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

If the vendor has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession, of fixed improvements placed on the property by the purchaser. If the vendor has previously transferred title to the purchaser, and the purchaser defaults in any of his payments and the vendor reacquires the property, such reacquisition shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of reacquisition, measured by the difference between the fair market value of the property reacquired, including the fair market value of fixed improvements placed on the property by the purchaser, and the basis in the hands of the vendor of the obligations of the purchaser (generally, the fair market value thereof which was previously recognized in computing income) which were applied by the vendor to the purchase or bid price of the property. The fair market value of the property reacquired shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition including the fair market value of the fixed improvements placed on the property by the purchaser.

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

ART. 44-5. *Gain or loss upon disposition of installment obligations.*—The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the Act, unless the disposition is within one of the exceptions made by the Act. Such an exception is provided in section 112 (b) (4) and (5), but not in section 112 (b) (6). The fact that section 112 (b) (6) provides for the nonrecognition of gain or loss upon the receipt of property by one corporation in complete liquidation of another corporation under certain specifically described circumstances is immaterial in determining the recognized gain or loss resulting to the liquidating corporation in case installment obligations are distributed in liquidation.

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

Example (1).—In 1934 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1916 at a cost of $10,000. During 1934 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 1936, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes it returns on the calendar year basis. The income to be reported for 1936 is $5,500, computed as follows:

Proceeds of sale of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Excess of face value of notes over amount of income returnable were the notes satisfied in full		7,500
Taxable income to be reported for 1936		5,500

Example (2).—Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1936 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 1936 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 1936	6,500

If the taxpayer, referred to in the above examples (1) and (2) as Corporation M, had been an individual, the taxable income to be reported, shown above as $5,500 and $6,500, respectively, would have been limited to 30 percent thereof by section 117 (a), the real estate having been held for more than 10 years prior to its sale in 1934.

In the case of decedents who die possessed of installment obligations, no gain on account of the transmission at death of such obligations is required to be reported as income in the return of the decedent for the year of his death, if the executor or administrator of the estate of the decedent or any of the next of kin or legatees files with the Commissioner a bond on Form 1132 in an amount not less than the amount by which the tax of the decedent for the year of his death would have been increased had no such bond been filed. The bond shall be conditioned upon the return as income, by any person receiving any payment in satisfaction of such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. The bond shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, shall be subject to the approval of the Commissioner, and must be filed at the time of filing the return of the decedent for the year of his death. See section 1126 of the Revenue Act of 1926, as amended (paragraph 31 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States.

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

SEC. 45. *Allocation of Income and Deductions.*—In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

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

(1) The term "*organization*" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Act or these regulations), irrespective of the place where organized, where operated, or where its

trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

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

(3) The term *"controlled"* includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form nor 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) *"Group"* or *"group of controlled taxpayers"* means 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 deduction, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, choose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 45 and this article apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

SEC. 46. *Change of Accounting Period.*—If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 47.

ART. 46-1. *Change in accounting period.*—If a taxpayer changes his accounting period he shall, prior to the expiration of 30 days from the close of the proposed period for which a return would be required to effect the change, furnish to the collector, for transmission to the Commissioner, the information required on Form 1128. The due date of the separate return for such period is the 15th day of the third month following the close of that period. If the change is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. (See section 47.)

SEC. 47. *Returns for a Period of Less Than Twelve Months.*—

(a) *Returns for short period resulting from change of accounting period.*—If a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

(b) *Income computed on basis of short period.*—Where a separate return is made under subsection (a) on account of a change in the accounting period, and in all other cases where a separate return is required or permitted, by regulations prescribed by the Commissioner with the approval of the Secretary, to be made for a fractional part of a year, then the income shall be computed on the basis of the period for which separate return is made.

(c) *Income placed on annual basis.*—If a separate return is made (except returns of the income of a corporation) under subsection (a) on account of a change in the accounting period, the net income, computed on the basis of the period for which separate return is made, shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in the period for which the separate return is made. The tax shall be such part of the tax computed on such annual basis as the number of months in such period is of twelve months.

(d) *Earned income.*—The Commissioner with the approval of the Secretary shall by regulations prescribe the method of applying the provisions of subsections (b) and (c) (relating to computing income on the basis of a short period, and placing such income on an annual basis) to cases where the taxpayer makes a separate return under subsection (a) on account of a change in the accounting period, and it appears that for the period for which the return is so made he has received earned income.

(e) *Reduction of credits against net income.*—In the case of a return made for a fractional part of a year, except a return made under subsection (a), on account of a change in the accounting period, the personal exemption and credit for dependents shall be reduced respectively to amounts which bear the same ratio to the full credits provided as the number of months in the period for which return is made bears to twelve months.

(f) *Closing of taxable year in case of jeopardy.*—For closing of taxable year in case of jeopardy, see section 146.

ART. 47-1. *Returns for periods of less than 12 months.*—No return can be made for a period of more than 12 months. A separate return for a fractional part of a year is therefore required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns in the several cases are stated in section 47 (a). The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time. (See sections 53 and 56.) If a return is made for a fractional part of a year, except where a return is made for a period of less than 12 months by reason of a change in accounting period, the personal exemption and credit for dependents shall be reduced to that proportion of the full credit which the number of months in the period for which the return is made bears to 12 months.

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

Example.—A citizen of the United States made a return for a 10-month period by reason of a change in accounting period. His net income including his earned net income for such 10-month period was $10,000, and his earned net income for such period was $4,000. He was entitled to a personal exemption of $2,500 but not to a credit for dependents. His tax for the period is $525.67, computed as follows:

Net income for 10-month period		$10,000.00
Multiplied by 12		120,000.00
Net income on annual basis ($120,000÷10)		12,000.00
Earned net income for 10-month period	$4,000.00	
Multiplied by 12	48,000.00	
Earned net income on annual basis ($48,000÷10)	4,800.00	
Subtracting:		
Earned income credit (10 percent of $4,800)	480.00	
Personal exemption	2,500.00	
		2,980.00
Net income subject to normal tax		9,020.00
Normal tax (4 percent of $9,020)		360.80
Surtax net income ($12,000 less personal exemption of $2,500)		9,500.00
Surtax on $9,500		270.00
Total tax on annual basis ($360.80+$270)		630.80
Amount of tax for period ($630.80×10/12)		525.67

The return of a decedent or of his estate for the year in which he died is a return for 12 months and not for a fractional part of a year.

SEC. 48. *Definitions.*—When used in this title—

(a) *Taxable year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. "Taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this title or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

(b) *Fiscal year.*—"Fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.

(c) *Paid, incurred, accrued.*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

(d) *Trade or business.*—The term "trade or business" includes the performance of the functions of a public office.

(e) *Mutual investment companies.*—

(1) *General definition.*—The term "mutual investment company" means any corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 351, if—

(A) It is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities; and

(B) At least 95 per centum of its gross income is derived from dividends, interest, and gains from sales or other disposition of stock or securities; and

(C) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than six months; and

(D) An amount not less than 90 per centum of its net income is distributed to its shareholders as taxable dividends during the taxable year; and

(E) Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof.

(2) LIMITATIONS.—Despite the provisions of paragraph (1) a corporation shall not be considered as a mutual investment company if, subsequent to a date thirty days after the date of the enactment of this Act, at any time during the taxable year—

(A) More than 5 per centum of the gross assets of the corporation, taken at cost, was invested in stock or securities, or both, of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to investments in obligations of the United States or in obligations of any corporation organized under general Act of Congress if such corporation is an instrumentality of the United States; or

(B) It owned more than 10 per centum of the outstanding stock or securities, or both, of any one corporation; or

(C) It had any outstanding bonds or indebtedness in excess of 10 per centum of its gross assets taken at cost; or

(D) It fails to comply with any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock.

ART. 48 (e)-1. *Taxation of mutual investment companies—General.*—If a corporation, as defined in section 1001, shows to the satisfaction of the Commissioner that it is entitled to the status of a mutual investment company, as defined in section 48 (e), it is allowed, under section 13 (a) (3), a credit for dividends paid, as provided in section 27, computed without the benefit of section 27 (b) relating to dividend carry-over, but under section 13 (a) (2) it is not allowed the credit for dividends received provided in section 26 (b). It is also required to keep records satisfactory to the Commissioner for the purpose of ascertaining the actual ownership of its outstanding stock. In all other respects a mutual investment company is treated, for purposes of taxation, as any other corporation subject to taxation under the Act.

ART. 48 (e)-2. *Definition of a mutual investment company.*—The term "mutual investment company" means a corporation whether chartered or incorporated, or created under a trust instrument or otherwise, as an investment trust, and whether of the fixed or general management type (other than a personal holding company as defined in section 351), which complies with all the conditions prescribed by section 48 (e). As to definition of a corporation see section 1001.

ART. 48 (e)-3. *Proof of status of a mutual investment company.*—(*a*) The Act requires that the company must have been organized for the purpose of, and that substantially all of its business must have consisted of, holding, investing or reinvesting in, stock or securities. It is not sufficient that the corporation is engaged in holding, investing or reinvesting in, stock or securities. It must have been organized for that purpose, and, throughout the taxable year, operated primarily as a medium through which contributing shareholders are offered centralized management and diversity of investments. If its predominant purpose is to hold, invest or reinvest in, stock or securities, and if substantially all of its business consists of holding, investing or reinvesting in, such stock or securities, the existence or exercise of incidental powers to engage in other business will not deprive a corporation of classification as a mutual investment company. A finance company, or a company engaged in the business of a dealer in stock or securities, or of a trader in stock or securities for its own account, is not a mutual investment company.

(*b*) The Act provides that at least 95 percent of the company's gross income for the taxable year must be derived from dividends, interest, and gains from sales or other disposition of stock or securities, and that less than 30 percent of the company's gross income for the taxable year must have been derived from the sale or other disposition of stock or securities held for less than six months. (See section 48 (e) (1) (B) and (C).) In determining the percentage of the company's gross income which has been derived from such sources, a loss from the sale or other disposition of stock or securities does not enter into the computation. The determination of the period for which stock or securities have been held shall be governed by the provisions of section 117 (c) in so far as applicable.

(*c*) The Act provides that an amount not less than 90 percent of the company's net income for the taxable year must have been distributed to its shareholders as taxable dividends during the taxable year. The term "taxable dividends" means dividends (as defined in section 115) which are taxable in the hands of such shareholders as are subject to taxation under Title I, and includes the proportionate share of the net earnings of the current year to the date of redemption distributed to the shareholder upon redemption. A taxable dividend is not distributed to its shareholders during the taxable year within the meaning of section 48 (e) (1) (D), unless the dividend is received by the shareholders during the taxable year of the company. See article 27 (a)-1, relating to the dividends paid credit allowed corporations.

(*d*) The Act requires that shareholders must, upon reasonable notice, be entitled at all times during the taxable year to redemption or purchase of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof, less a discount not in excess of 3 percent thereof. Redemption within 60 days of written notice is redemption upon reasonable notice, even though subject to exception in case of extraordinary crises.

(*e*) Corporations are given 30 days after June 22, 1936, the date of the enactment of the Act, within which to comply with the provisions of section 48 (e) (2). Although a corporation may be otherwise classified as a mutual investment company, it will not be considered such for any taxable year if at any time (after July 22, 1936) during the taxable year it failed to comply with section 48 (e) (2).

ART. 48 (e)-4. *Records to be kept for purpose of ascertaining actual ownership of outstanding stock of mutual investment companies.*—Every mutual investment company shall maintain in the collection district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by these regulations to be demanded from the shareholders. The term "actual owner of stock", as used in these regulations, includes the person who is required to include in gross income in his return the dividends received on the stock. All such records shall be open for inspection, by any duly authorized officer or employee of the Bureau of Internal Revenue, for a period of four years from the end of the taxable year of the company to which they relate.

A mutual investment company shall demand of each of its shareholders (or in the case of a company all or substantially all of the capital stock of which is held by trustees for the purpose of exercising voting rights, such company shall demand of each of the registered holders of certificates of beneficial interest in the company) on or before the payment of any dividend made after 30 days from August 18, 1936, a written statement giving (1) the name and address of the actual owner as of the date the shareholder becomes entitled to the dividend, whether payable then or later, of the stock with respect to which the dividend is payable, (2) the name and address of the person who executes the statement, and (3) the number of shares to which the statement pertains, or, if the statement is made by the actual owner, the total number of shares actually owned by such person.

At the time the first demand is made after the expiration of 30 days from August 18, 1936, a like statement shall be demanded with respect to any prior dividends paid within the taxable year.

ART. 48 (e)-5. *Records to be kept for purpose of determining whether a company claiming to be a mutual investment company is a personal holding company.*—For the purpose of determining whether a company claiming to be a mutual investment company is a personal holding company as defined in section 351, the permanent records of the company shall show the additional information required by these regulations disclosing the maximum number of shares actually owned by each person at any time during the last half of the company's taxable year. In the case of an individual actual owner, the information shall give, to the best of the knowledge and belief of such owner, the names and addresses of, and the maximum number of shares actually owned by, each member of his family (as defined in section 351 (b) (1)) at any time during the last half of the company's taxable year. In case the actual owner is a corporation, partnership, estate, or trust, the information shall also give the names and addresses and the proportionate interests of such shareholders, partners, or beneficiaries, who had beneficial interests to the extent of at least 10 percent at any time during the last half of the mutual investment company's taxable year. Statements giving such additional information shall be demanded not later than 30 days after the close of the company's taxable year, as follows:

(1) In the case of a company having 2,000 or more actual owners of its stock on any dividend payment date, as disclosed by statements received in response to demands made by the company as provided in article 48 (e)-4, from each person so disclosed or known to the company as the actual owner of 5 percent or more of its stock; or

(2) in the case of a company having less than 2,000 and more than 200 actual owners of its stock as so disclosed, from each person so disclosed or known to the company as actually owning 1 percent or more of its stock; or

(3) in the case of a company having 200 or less actual owners of its stock, from each person who is the actual owner of one-half of 1 percent or more of its stock.

ART. 48 (e)-6. *Additional information required in returns of shareholders.*—Any person who fails or refuses to comply with the demand of a mutual investment company for the written statements which articles 48 (e)-4 and 48 (e)-5 require the company to demand from its shareholders shall submit as a part of the income tax return required by the Act of such person a statement showing, to the best of his knowledge and belief—

(1) the number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a mutual investment company;

(2) the dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(3) the dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(4) the names and addresses of the members of his family, as defined in section 351 relating to personal holding companies; and the maximum number of shares, if any, actually owned by each in any company claiming to be a mutual investment company, at any time during the last half of the taxable year of such company;

(5) the names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any company claiming to be a mutual investment company actually owned by each; and

(6) the amount and date of receipt of each dividend received during such period from every company claiming to be a mutual investment company.

When making demand for the written statements required of each shareholder under these regulations, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by this article if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its records required by these regulations. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by these regulations, or which may be required from time to time by any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for such purpose, shall not be taxable as a mutual investment company.

Nothing in these regulations shall be construed to relieve mutual investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under sections 147 and 148.

CHAPTER VIII

Returns and Payment of Tax

Part V—Returns and Payment of Tax

SEC. 51. *Individual Returns.*—

(a) *Requirement.*—The following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,500 or over, if married and living with husband or wife; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.

(b) *Husband and wife.*—If a husband and wife living together have an aggregate net income for the taxable year of $2,500 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

(c) *Persons under disability.*—If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

(d) *Fiduciaries.*—For returns to be made by fiduciaries, see section 142.

ART. 51–1. *Individual returns.*—For each taxable year every single person and every married person not living with husband or wife for any part of the taxable year, whose gross income as defined in sections 22 and 116 is $5,000 or over, or whose net income as defined in section 21 is $1,000 or over, must make a return of income. Every married person living with husband or wife for any part of the taxable year, but not at the close of the taxable year, must make a return if his gross income for the taxable year is $5,000 or more, or his net income is equal to, or in excess of, the credit allowed him by section 25 (b) (1) and (3) (computed without regard to his status as the head of a family). (See article 25–7.) A husband and wife living together for the entire year need make no returns unless their aggregate gross income for the taxable year is at least $5,000, or their aggregate net income is at least $2,500. Of their aggregate net income for the taxable year is $2,500 or more, or their aggregate gross income is $5,000 or more, either each must make a return, or the income of each must be included in a single joint return. A husband and wife living together at the close of the taxable year but not during the entire taxable year must make a return or returns if their aggregate gross income for the taxable year is $5,000 or more, or their aggregate net income 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 the head of a family). (See article 25–7.) If the income of each is included in a single joint return, the tax is computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. A joint return of husband and wife may be filed only if they were living together at the close of their taxable year. 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.

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

The joint return of a husband and wife must be sworn to before an officer duly authorized to administer oaths (see article 51–4) by the spouse preparing the return. The spouse who fills in the return shall be considered to have prepared the return within the meaning of this paragraph. If the return is prepared by both spouses, or is prepared by neither spouse, then both spouses shall swear to the return, except where one spouse acts for the other spouse under a power of attorney submitted on Form 936, or the return is made by an agent by reason of illness or absence, as provided in article 51–2.

Whether or not an individual is the head of a family or has dependents is immaterial in determining his liability to render a return. For returns by fiduciaries, see section 142; by partnerships, see section 187; and by nonresident alien individuals, see section 217. See also section 53.

ART. 51–2. *Form of return.*—The return shall be on Form 1040, except that it may be on short Form 1040A if the net income does not exceed $5,000, and is derived chiefly from salaries and wages. The forms may be had from the collectors of the several districts. The return may be made by an agent if, by reason of illness, the person liable for the making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the return. Whenever a return is made by an agent (except returns on Form 1040NB for nonresident aliens not engaged in trade or busines in the United States and not having an office or place of business therein, see article 217–2) it must be accompanied by the prescribed power of attorney, Form 935. The taxpayer and his agent, if any, are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns. For returns of nonresident aliens, see articles 217–1 and 217–2.

The home or residental address of the taxpayer (including the street and number, if any) shall be given in the space provided at the top of the return for the name and address of the taxpayer. A taxpayer having a permanent business address may give that address as the principal or mailing address, provided that the complete home or residential address is also given within the space provided.

ART. 51–3. *Return of income of minor.*—An individual, although a minor, is required to render a return of income if he has a net income of his own of $1,000 or over, or a gross income of $5,000 or over, for the taxable year. If he is married, see article 51–1. If under the laws of a State the earnings of a minor belong to the minor, such earnings, regardless of amount, are not required to be included in the return of the parent. If the aggregate of the net income of a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings which belong to him, is at least $1,000, or his gross income is at least $5,000, a return, as in the case of any other individual, must be made by him or for him by his guardian, or other person charged with the care of his person or property. (See article 142–2.) In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return.

ART. 51–4. *Verification of returns.*—All income tax returns must be verified under oath or affirmation. The oath or affirmation may be administered by any officer 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, wherein such oath 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 official having no seal shall 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.

ART. 51-5. *Use of prescribed forms.*—Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Returns which have not been so prepared will not be accepted as meeting the requirements of the Act. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time the statement so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form. (See further articles 53-2 to 53-4.)

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

ART. 52-1. *Corporation returns.*—Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120. For returns of insurance companies, see articles 201 (b)-1, 204 (a)-1, and 207-7; of foreign corporations, see section 235; and of affiliated corporations, see section 141 and article 141-1. A corporation having an existence during any portion of a taxable year is required to make a return. A corporation which has received a charter, but has never perfected its organization, which has transacted no business and had no income from any source, may upon presentation of the facts to the collector be relieved from the necessity of making a return as long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. A corporation which was dissolved in 1936 prior to the enactment of the Revenue Act of 1936 is not relieved from the necessity of rendering returns thereunder for any period or periods of its existence for which the Act is effective. For information returns by corporations relating to profits of the taxable year declared as dividends, see section 148 (b). For verification of returns and use of prescribed forms, see articles 51-4 and 51-5. Upon liquidation or dissolution of a corporation there shall be attached to the final return a statement showing: (1) The date and manner of dissolution, (2) the name and address of each shareholder at dissolution and the number and par value of the shares of stock held by each of them, (3) a description and the value of the liquidating assets received by each shareholder, (4) the name and address of each individual or corporation other than shareholders and creditors, if any, that received assets at dissolution, (5) a description and the value of the assets received by each such individual or corporation, and (6) the consideration, if any, paid by each of them for the assets received.

ART. 52-2. *Returns by receivers.*—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. (See sections 274 and 298 and articles 274-1 and 274-2.) A receiver in charge of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.

SEC. 53. *Time and Place for Filing Returns.*—
(a) *Time for filing.*—

(1) *General rule.*—Returns made on the basis of the calendar year shall be made on or before the 15th day of March following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the third month following the close of the fiscal year.

(2) *Extension of time.*—The Commissioner may grant a reasonable extension of time for filing returns, under such rules and regulations as he shall prescribe with the approval of the Secretary. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) *To whom return made.*—

(1) *Individuals.*—Returns (other than corporation returns) shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

(2) *Corporations.*—Returns of corporations shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

ART. 53-1. *Time for filing returns.*—Returns of income (except in the case of nonresident alien individuals, as to which see section 217, and foreign corporations, as to which see section 235) must be made on or before the 15th day of the third month following the close of the taxable year. A corporation going into liquidation during any taxable year may, upon the completion of such liquidation, prepare a return for that year covering its income for the part of the year during which it was engaged in business and may immediately file such return with the collector.

ART. 53-2. *Extensions of time for filing returns.*—It is important that the taxpayer render on or before the due date a return as nearly complete and final as it is possible for him to prepare. However, the Commissioner is authorized to grant a reasonable extension of time for filing returns under such rules and regulations as he shall prescribe with the approval of the Secretary. Accordingly, authority for granting extensions of time for filing income tax returns is hereby delegated to the various collectors of internal revenue. Application for extensions of time for filing income tax returns should be addressed to the collector of internal revenue for the district in which the taxpayer files his returns and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing income tax returns may be granted for more than six months. For extensions of time for payment of tax, see sections 56 (c) and 272 (j) and articles 53-3, 56-2, and 272-3.

ART. 53-3. *Extensions of time in the case of foreign organizations, certain domestic corporations, and citizens of United States residing or traveling abroad.*—An extension of time for filing returns of income for taxable years begun after December 31, 1935, is hereby granted up to and including the 15th day of the sixth month following the close of the taxable year in the case of:

(*a*) Foreign partnerships regardless of whether they maintain an office or place of business within the United States;

(*b*) Foreign corporations which maintain an office or place of business within the United States;

(*c*) Domestic corporations which transact their business and keep their records and books of account abroad;

(*d*) Domestic corporations whose principal income is from sources within the possessions of the United States; and

(*e*) American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States.

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

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

ART. 53-4. *Due date of return.*—The due date is the date on or before which a return is required to be filed in accordance with the provisions of the Act or the last day of the period covered by an extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the due date for filing returns will be the day following such Sunday or legal holiday. If placed in the mails, the returns should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. If a question may be raised as to whether the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

ART. 53-5. *Place for filing individual returns.*—Section 53 (b) (1) provides that individual returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Md.

An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of section 53 (b) (1), and shall make his return to the collector for the district in which is located his legal residence, or, if he has no legal residence in the United States, then to the collector at Baltimore, Md.

SEC. 54. *Records and Special Returns.*—

(a) *By taxpayer.*—Every person liable to any tax imposed by this title or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

(b) *To determine liability to tax.*—Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return, render under oath such statements, or keep such records, as the Commissioner deems sufficient to show whether or not such person is liable to tax under this title.

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

(d) *Copies of returns.*—If any person, required by law or regulations made pursuant to law to file a copy of any income return for any taxable year, fails to file such copy at the time required, there shall be due and assessed against such person $5 in the case of an individual return or $10 in the case of a fiduciary, partnership, or corporation return, and the collector with whom the return is filed shall prepare such copy. Such amount shall be collected and paid, without interest, in the same manner as the amount of tax due in excess of that shown by the taxpayer upon a return in the case of a mathematical error appearing on the face of the return. Copies of returns filed or prepared pursuant to this subsection shall remain on file for a period of not less than two years from the date they are required to be filed, and may be destroyed at any time thereafter under the direction of the Commissioner.

ART. 54-1. *Aids to collection of tax.*—The Commissioner may require any person to keep specific records, render under oath such statements and returns, and comply with such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, in order that he may determine whether such person is liable for the tax or for the collection thereof. In accordance with this provision, every person subject to tax carrying on the business of producing, manufacturing, purchasing, or selling any commodities or merchandise, except the business of growing and selling products of the soil, shall for the purpose of determining the amount of income which may be subject to the tax keep such permanent books of account or records, including inventories, as are necessary to establish the amount of his gross income and the deductions, credits, and other information required to be shown in an income tax return. Forms relating to Federal income taxes shall be prescribed by the Commissioner and filled in according to the instructions contained thereon and the regulations applicable thereto.

SEC. 55. *Publicity of returns.*—

(a) Returns made under this title shall be open to inspection in the same manner, to the same extent, and subject to the same provisions of law, including penalties, as returns made under Title II of the Revenue Act of 1926; and all returns made under this Act shall constitute public records and shall be open to public examination and inspection to such extent as shall be authorized in rules and regulations promulgated by the President.

(b) (1) All income returns filed under this title (or copies thereof, if so prescribed by regulations made under this subsection), shall be open to inspection by any official, body, or commission, lawfully charged with the administration of any State tax law, if the inspection is for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in paragraph (2). The inspection shall be permitted only upon written request of the governor of such State, designating the representative of such official, body, or commission to make the inspection on behalf of such official, body, or commission. The inspection shall be made in such manner, and at such times and places, as shall be prescribed by regulations made by the Commissioner with the approval of the Secretary.

(2) Any information thus secured by any official, body, or commission of any State may be used only for the administration of the tax laws of such State, except that upon written request of the Governor of such State any such information may be furnished to any official, body, or commission of any political subdivision of such State, lawfully charged with the administration of the tax laws of such political subdivision, but may be furnished only for the purpose of, and may be used only for, the administration of such tax laws. Any officer, employee, or agent of any State or political subdivision, who divulges (except as authorized in this subsection, or when called upon to testify in any judicial or administrative proceeding to which the State or political subdivision, or such State or local official, body, or commission, as such, is a party) any information acquired by him through an inspection permitted him or another under this subsection shall be guilty of a misdemeanor and shall upon conviction be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both.

ART. 55 (b)-1. *Definitions.*—Any word or term used in this article and articles 55 (b)-2 to 55 (b)-4, inclusive, which is defined in the Act shall be given the respective definition contained in the Act.

ART. 55 (b)-2. *Copies of income returns.*—Every person (except nonresident alien individuals, nonresident alien fiduciaries, nonresident foreign partnerships, and nonresident foreign corporations) required to file an income return (including affiliation schedules) under the provisions of sections 51, 52, 141, 142, or 187 of Title I of the Revenue Act of 1936, or section 351 of Title IA of that Act, or section 106 of the Revenue Act of 1935, as amended by section 402 of the Revenue Act of 1936, for any taxable year beginning after December 31, 1935, shall file with the return a copy thereof on a duplicate form on colored paper which will be provided for that purpose. The copy on such duplicate form shall be a complete duplicate of the return as filed except that the affidavits on the duplicate form need not be filled in. There shall be attached to the copy on the duplicate form a copy of any schedule or statement attached to the original return except (1) Schedule C-1 in the case of a corporation return, (2) the copy of the will or trust instrument in the case of a fiduciary return, (3) the power of attorney on Form 935 or Form 936 in the case of a return made by an agent, and (4) the copy of the annual statement made to the insurance department of the State, Territory, or District of Columbia in the case of a return of an insurance company. In lieu of filling in the duplicate form on colored paper, a legible photostat or photograph of the return and related schedules as filed may be filed with the return provided such photostat or photograph is not of larger dimensions than the return and is securely fastened to the duplicate form. For amounts to be assessed and collected in the case of the failure to file a copy of any income return required by law or regulations, see section 54 (d).

ART. 55 (b)-3. *Inspection of copies of returns.*—Within a reasonable time after the returns are filed the copies thereof (including photostats and photographs), under such procedure as may be prescribed by the Commissioner, shall be made available for inspection in the office of the collector of internal revenue in which the returns are filed, by any official, body, or commission, lawfully charged with the administration of any State tax law, or by the representatives of such official, body, or commission designated in writing by the governor of the State, for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in section 55 (b) (2). The governors of the respective States shall be notified by the Commissioner of the date the copies of the returns are available for inspection and inspection thereof shall not be permitted after one year from such date.

ART. 55 (b)-4. *Request for permission to inspect copies.*—Requests for permission to inspect the copies of returns must be in writing signed by the governor under the seal of his State, and must be addressed to the Commissioner of Internal Revenue, Records Division, Washington, D. C. The request must state (*a*) the kind of returns it is desired to inspect, (*b*) the taxable year or years covered by the copies of returns it is desired to inspect, (*c*) the name of the official, body, or commission by whom or which the inspection is to be made, (*d*) the name of the representative of such official, body, or commission, designated to make the inspection, (*e*) by specific references, the State tax law which such official, body, or commission is charged with administering and the law under which he, she, or it is so charged, (*f*) the purpose for which the inspection is to be made, and (*g*) if the inspection is for the purpose of obtaining information to be furnished to local taxing authorities, (1) the name of the official, body, or commission of any political subdivision of the State, lawfully charged with the administration of the tax laws of such political subdivision, if any, to whom or to which the information secured by the inspection is to be furnished, and (2) the purpose for which the information is to be used by such official, body, or commission.

SEC. 56. *Payment of Tax.*—

(a) *Time of payment.*—The total amount of tax imposed by this title shall be paid on the fifteenth day of March following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the third month following the close of the fiscal year.

(b) *Installment payments.*—The taxpayer may elect to pay the tax in four equal installments, in which case the first installment shall be paid on the date prescribed for the payment of the tax by the taxpayer, the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after such date. If any installment is not paid on or before the date fixed for its payment, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.

(c) *Extension of time for payment.*—At the request of the taxpayer, the Commissioner may extend the time for payment of the amount determined as the tax by the taxpayer, or any installment thereof, for a period not to exceed six months from the date prescribed for the payment of the tax or an installment thereof. In such case the amount in respect of which the extension is granted shall be paid on or before the date of the expiration of the period of the extension.

(d) *Voluntary advance payment.*—A tax imposed by this title, or any installment thereof, may be paid, at the election of the taxpayer, prior to the date prescribed for its payment.

(e) *Advance payment in case of jeopardy.*—For advance payment in case of jeopardy, see section 146.

(f) *Tax withheld at source.*—For requirement of withholding tax at the source in the case of nonresident aliens and foreign corporations, and in the case of so-called tax-free covenant bonds, see section 143 and 144.

(g) *Fractional parts of cent.*—In the payment of any tax under this title a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent .

(h) *Receipts.*—Every collector whom any payment of any income tax is made shall upon request give to the person making such payment a full written or printed receipt therefor.

ART. 56-1. *Date on which tax shall be paid.*—The tax, unless it is required to be withheld at the source (see sections 143 and 144) or unless it is to be paid by a nonresident alien individual (see section 218) or a foreign corporation not having any office or place of business in the United States (see section 236), is to be paid on or before the 15th day of March following the close of the calendar year, or, if the return is made on the basis of a fiscal year, on or before the 15th day of the third month following the close of such fiscal year. But see article 53-3. The tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment either by the Act or by the Commissioner in accordance with the terms of an extension, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.

ART. 56-2. *Extension of time for payment of the tax or installment thereof.*—If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner, at the request of the taxpayer, may grant an extension of time for the payment for a period not to exceed six months from the date prescribed for the payment of such amount, part, or installment. 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 amount at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

An application for an extension of time for the payment of such tax should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer is required and should accompany the application. An itemized statement showing all receipts and disbursements for each of the three months preceding the due date of the tax shall also be submitted. The application with the evidence must be filed with the collector, who will at once transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner it will be examined immediately and, if possible, within 30 days will be rejected, approved or tentatively approved, subject to certain conditions of which the taxpayer will be immediately notified. The Commissioner will not consider an application for an extension of time for the payment of a tax unless such application is made in writing, and is made to the collector on or before the due date of the tax or installment thereof for which the extension is desired, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1130 in an amount not exceeding double the amount of the tax or to furnish other security satisfactory to the Commissioner for the payment of the tax, or installment thereof, on the date 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 must be filed with the collector within 10 days after notification by the Commissioner that such 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 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 Liberty bonds or other bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax, or installment thereof. (See section 1126 of the Revenue Act of 1926, as amended, paragraph 31 of the Appendix to these regulations.) A request by the taxpayer for an extension of time for the payment of one installment does not operate to procure an extension of time for payment of subsequent installments. Nor does an extension of time for filing a return operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension. If an extension of time for payment of the tax or any installment is granted, the amount, time for payment of which is so extended, shall be paid on or before the expiration of the period of the extension, together with interest at the rate of 6 percent per annum on such amount from the date when the payment should have been made if no extension had been granted until the expiration of the period of the extension. (See section 295.)

ART. 56-3. *When fractional part of cent may be disregarded.*—In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent. Fractional parts of a cent should not be disregarded in the computation of taxes.

ART. 56-4. *Receipts for tax payments.*—Upon request a collector will give a receipt for each tax payment. In the case of payments made by check or money order the canceled check or the money order receipt is usually a sufficient receipt. In the case of payments in cash, however, the taxpayer should in every instance require and the collector should furnish a receipt.

SEC. 57. *Examination of Return and Determination of Tax.*—As soon as practicable after the return is filed the Commissioner shall examine it and shall determine the correct amount of the tax.

ART. 57-1. *Examination of return and determination of tax by the Commissioner.*—As soon as practicable after returns are filed, they will be examined and the correct amount of the tax determined under such procedure as may be prescribed from time to time by the Commissioner. (See section 272.)

SEC. 58. *Additions to Tax and Penalties.*—(a) For additions to the tax in case of negligence or fraud in the nonpayment of tax or failure to file return therefor, see Supplement M.

(b) For criminal penalties for nonpayment of tax or failure to file return therefor, see section 145.

SEC. 59. *Administrative Proceedings.*—For administrative proceedings in respect of the nonpayment or overpayment of a tax imposed by this title, see as follows:

(a) Supplement L, relating to assessment and collection of deficiencies.

(b) Supplement M, relating to interest and additions to tax.

(c) Supplement N, relating to claims against transferees and fiduciaries.

(d) Supplement O, relating to overpayments.

CHAPTER IX

Miscellaneous Provisions

Part VI—Miscellaneous Provisions

SEC. 61. *Laws Made Applicable.*—All administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this title.

SEC. 62. *Rules and Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

SEC. 63. *Taxes in Lieu of Taxes Under 1934 Act.*—The taxes imposed by this title and Title IA shall be in lieu of the taxes imposed by Titles I and IA of the Revenue Act of 1934, as amended.

SEC. 64. *Short Title.*—This title may be cited as the "Income Tax Act of 1936."

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[*Chapters X–XXXIII (Supplemental Provisions, Subtitle C of Title I) will appear in the Federal Register for Tuesday, November 17, 1936. Chapters XXXIV (Surtax on Personal Holding Companies, Title IA) and XXXV (General Provisions, Title VIII), and the Appendix will appear in the Federal Register for Wednesday, November 18, 1936.*]

[SEAL] CHAS. T. RUSSELL,
Acting Commissioner of Internal Revenue.

Approved: November 12, 1936.

WAYNE C. TAYLOR,
Acting Secretary of the Treasury.

[F. R. Doc. 3378—Filed, November 13, 1936; 1:05 p. m.]

INTERSTATE COMMERCE COMMISSION.

ORDER

At a Session of the Interstate Commerce Commission, Division 5, held at its office in Washington, D. C., on the 10th day of November A. D. 1936.

[No. MC 20987]

APPLICATION OF C. M. DEKAY FOR AUTHORITY TO OPERATE AS A COMMON CARRIER

In the Matter of the Application of C. M. Dekay, Individual, Doing Business as D. & H. Motor Freight Co., of 417 Charles Street, Jamestown, N. Y., for a Certificate of Public Convenience and Necessity (Form BMC 1), Authorizing Operation as a Common Carrier by Motor Vehicle in the Transportation of Commodities Generally, in Interstate Commerce, From and Between Points Located in the States of Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and District of Columbia, Over Irregular Routes and Over the Following Regular Routes

Route No. 1.—Between Jamestown and New York, N. Y.

Route No. 2.—Between Jamestown, N. Y., and Philadelphia, Pa.

Route No. 3.—Between Jamestown, N. Y., and Washington, D. C.

Route No. 4.—Between Jamestown and Buffalo, N. Y.

Route No. 5.—Between Jamestown, N. Y., and Youngsville, Pa.

A more detailed statement of route or routes (or territory) is contained in said application, copies of which are on file and may be inspected at the office of the Interstate Commerce Commission, Washington, D. C., or offices of the boards, commissions, or officials of the States involved in this application.

It appearing, That the above-entitled matter is one which the Commission is authorized by the Motor Carrier Act, 1935, to refer to an examiner:

It is ordered, That the above-entitled matter be, and it is hereby, referred to Examiner T. Naftalin for hearing on the 30th day of November A. D. 1936, at 10 o'clock a. m. (standard time), at the Federal Building, Jamestown, N. Y., and for recommendation of an appropriate order thereon accompanied by the reasons therefor;

It is further ordered, That notice of this proceeding be duly given;

And it is further ordered, That any party desiring to be notified of any change in the time or place of the said hearing (at his own expense if telegraphic notice becomes necessary) shall advise the Bureau of Motor Carriers of the Commission, Washington, D. C., to that effect by notice which must reach the said Bureau within 10 days from the date of service hereof and that the date of mailing of this notice shall be considered as the time when said notice is served.

By the Commission, division 5.

[SEAL] GEORGE B. MCGINTY, *Secretary*.

[F. R. Doc. 3371—Filed, November 13, 1936; 11:49 a. m.]

[Fourth Section Application No. 16606]

HANDLES FROM, TO, AND BETWEEN POINTS IN THE SOUTHWEST

NOVEMBER 13, 1936.

The Commission is in receipt of the above-entitled and numbered application for relief from the long-and-short-haul provision of section 4 (1) of the Interstate Commerce Act.

Filed by: F. A. Leland, Agent.
Commodities involved: Handles, broom or mop, with or without metal hooks or hangers attached, in carloads.
From, to, and between: Points in the Southwest.
Grounds for relief: Analogous commodity.

Any interested party desiring the Commission to hold a hearing upon such application shall request the Commission in writing so to do within 15 days from the date of this notice; otherwise the Commission may proceed to investigate and determine the matters involved in such application without further or formal hearing.

By the Commission, division 2.

[SEAL] GEORGE B. MCGINTY, *Secretary*.

[F. R. Doc. 3372—Filed, November 13, 1936; 11:49 a. m.]

SECURITIES AND EXCHANGE COMMISSION.

SECURITIES ACT OF 1933

ADOPTION OF RULE 600—FINANCIAL STATEMENTS

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, as amended, particularly Sections 7 and 19 (a) thereof, and finding that the information specified in Schedule A of the Act which is permitted by Rule 600 to be omitted from any registration statement in respect of a specified class of issuers is inapplicable to such class, and that disclosure fully adequate for the protection of investors is otherwise required to be included in the registration statement, and that any information not specified in Schedule A which is required by such rule to be set forth in the registration statement is necessary and appropriate in the public interest and for the protection of investors, and that Rule 600 is necessary to carry out the provisions of the Act and is necessary and appropriate in the public interest and for the protection of investors, hereby takes the following action:

The following new rule is adopted, to be inserted in Article 3 of Regulation C of the "General Rules and Regulations under the Securities Act of 1933", under a new caption as follows:

C. Financial Statements

RULE 600. *Special Financial Requirements in Case Registrant is a Natural Person.*—A registrant who is a natural person may file, in lieu of the balance sheets and profit and loss statements otherwise required in the appropriate form for registration or the instructions accompanying such form, the following financial statements:

(a) A statement of assets and liabilities of the registrant as of a date within ninety days, and statements of the regisrant's income year by year for the three calendar years preceding the date of such statement of assets and liabilities. These statements shall be set forth in reasonable detail and need not be certified.

(b) Balance sheets and profit and loss statements of:

(i) Every business of which the registrant is sole proprietor;

(ii) Every partnership in which the registrant has a controlling interest;

(iii) Every business trust, unincorporated association, or similar business organization in which the registrant has a controlling interest; and

(iv) Every corporation in which the registrant owns directly or indirectly securities representing more than 50% of the voting power other than as affected by events of default.

Such financial statements need not be filed, however, with respect to any corporation or other business organization designated in (iii) or (iv) above if both of the following conditions exist:

(1) The registrant's total investment in such corporation or business organization does not exceed 5% of the registrant's total assets;

(2) The registrant's total income from such corporation or business organization does not exceed 5% of the registrant's gross income;

provided that the registrant's aggregate investment in all such corporations and business organizations whose statements are omitted pursuant to this sentence shall not exceed 15% of the registrant's total assets, and that the registrant's aggregate income from all such corporations and business organizations shall not exceed 15% of the registrant's gross income.

Financial statements required by this paragraph (b) shall be for the dates and periods prescribed for the financial statements of an unconsolidated subsidiary in the appropriate form for registration. Such statements shall also conform, so far as practicable, to all other requirements as to financial statements, including requirements as to certification, as set forth in such form.

The foregoing amendment shall be effective immediately upon publication.

By the Commission.

[SEAL] FRANCIS P. BRASSOR, *Secretary*.

[F. R. Doc. 3374—Filed, November 13, 1936; 12:50 p. m.]

United States of America—Before the Securities and Exchange Commission

At a regular session of the Securities and Exchange Commission held at its office in the City of Washington, D. C., on the 12th day of November A. D. 1936.

IN THE MATTER OF AN OFFERING SHEET OF A ROYALTY INTEREST IN THE MAGNOLIA-ROGERS FARM, FILED ON OCTOBER 19, 1936, BY W. H. CARRAHER, RESPONDENT

ORDER TERMINATING PROCEEDING AFTER AMENDMENT

The Securities and Exchange Commission, finding that the offering sheet filed with the Commission, which is the subject of this proceeding, has been amended, so far as necessary, in accordance with the Suspension Order previously entered in this proceeding;[1]

It is ordered, pursuant to Rule 341 (d) of the Commission's General Rules and Regulations under the Securities Act of 1933, as amended, that the amendment received at the office of the Commission on November 9, 1936, be effective as of November 9, 1936; and

It is further ordered, that the Suspension Order, Order for Hearing, and Order Designating a Trial Examiner, heretofore entered in this proceeding, be, and the same hereby are, revoked and the said proceeding terminated.

By the Commission.

[SEAL] FRANCIS P. BRASSOR, *Secretary*.

[F. R. Doc. 3377—Filed, November 13, 1936; 12:50 p. m.]

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[1] F. R. 1957.

United States of America—Before the Securities and Exchange Commission

At a regular session of the Securities and Exchange Commission held at its office in the City of Washington, D. C., on the 12th day of November A. D. 1936.

IN THE MATTER OF AN OFFERING SHEET OF A ROYALTY INTEREST IN THE SUNRAY ET AL.-CAPITAL-MANSION-STATE ET AL. FARM, FILED ON NOVEMBER 6, 1936, BY T. G. THOMPSON, RESPONDENT

SUSPENSION ORDER, ORDER FOR HEARING (UNDER RULE 340 (A)), AND ORDER DESIGNATING TRIAL EXAMINER

The Securities and Exchange Commission, having reasonable grounds to believe, and therefore alleging, that the offering sheet described in the title hereof and filed by the respondent named therein is incomplete or inaccurate in the following material respects, to wit:

1. In that the date in Division I when the information contained in the offering sheet will be out of date is miscalculated based on Items 15 and 16 (a) of Division II thereof;

2. In that in Item 1 of Division II the participation stated for each smallest fractional interest is incorrectly stated or miscalculated and appears inconsistent with the note to Item 16 (c);

It is ordered, pursuant to Rule 340 (a) of the Commission's General Rules and Regulations under the Securities Act of 1933, as amended, that the effectiveness of the filing of said offering sheet be, and hereby is, suspended until the 12th day of December 1936; that an opportunity for hearing be given to the said respondent for the purpose of determining the material completeness or accuracy of the said offering sheet in the respects in which it is herein alleged to be incomplete or inaccurate, and whether the said order of suspension shall be revoked or continued; and

It is further ordered, that John H. Small, an officer of the Commission, be, and hereby is, designated as trial examiner to preside at such hearing, to continue or adjourn the said hearing from time to time, to administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, consider any amendments to said offering sheet as may be filed prior to the conclusion of the hearing, and require the production of any books, papers, correspondence, memoranda, or other records deemed relevant or material to the inquiry, and to perform all other duties in connection therewith authorized by law; and

It is further ordered, that the taking of testimony in this proceeding commence on the 25th day of November 1936 at 10:00 o'clock in the forenoon at the office of the Securities and Exchange Commission, 18th Street and Pennsylvania Avenue, Washington, D. C., and continue thereafter at such times and places as said examiner may designate.

Upon the completion of testimony in this matter the examiner is directed to close the hearing and make his report to the Commission.

By the Commission.

[SEAL] FRANCIS P. BRASSOR, *Secretary*.

[F. R. Doc. 3376—Filed, November 13, 1936; 12:50 p. m.]

United States of America—Before the Securities and Exchange Commission

At a regular session of the Securities and Exchange Commission held at its office in the City of Washington, D. C., on the 12th day of November A. D. 1936.

[File No. 20—189A1-1]

IN THE MATTER OF AN OFFERING SHEET OF ROYALTY INTERESTS IN THE PURE OIL CO.-R. L. WELLS NO. 47 LEASE, FILED ON JULY 9, 1936, BY P. R. KNICKERBOCKER, RESPONDENT

PERMANENT SUSPENSION ORDER

The Securities and Exchange Commission initiated this proceeding pursuant to the provisions of Rule 340 of the General Rules and Regulations promulgated by the Commission under the Securities Act of 1933, as amended, to determine whether or not an order should be entered suspending the effectiveness of the filing of an offering sheet of royalty interests in the Pure Oil Co.-R. L. Wells No. 47 Lease, located in Van Zandt County, Texas, which offering sheet was filed with the Commission on July 9, 1936, by P. R. Knickerbocker, of Dallas, Texas, the respondent herein.

This matter having come on regularly for hearing before the Commission at Washington, D. C., on July 29, 1936, and due notice thereof having been given to the said respondent,[1] and the said respondent having failed to appear, and evidence both oral and documentary having been introduced, and the hearing having been closed, and the Commission having found upon the evidence that said offering sheet omits to state material facts required to be stated therein (for the omission of which no sufficient reason is given in said offering sheet) and which are necessary to make the statements therein not misleading, all as more fully set forth in the Findings and Opinion of the Commission filed in this proceeding, and it appearing appropriate in the public interest so to do;

It is ordered, pursuant to Rule 340 (b) of the Commission's General Rules and Regulations promulgated under the Securities Act of 1933, as amended, that the effectiveness of the filing of said offering sheet be, and same hereby is, permanently suspended.

By the Commission.

[SEAL] FRANCIS P. BRASSOR, *Secretary*.

[F. R. Doc. 3375—Filed, November 13, 1936; 12:50 p. m.]

UNITED STATES TARIFF COMMISSION.

PUBLIC NOTICE

INVESTIGATION ORDERED AND HEARING SET: CIGAR LIGHTERS

[Docket 11; Section 337, Tariff Act of 1930]

In the Matter of Investigation of Alleged Unfair Methods of Competition or Unfair Acts in the Importation or Sale of Cigar Lighters

Upon consideration of the complaint under oath filed on the 28th day of December 1935, by Art Metal Works, Inc., having its principal place of business in Newark, New Jersey, it was, on August 14, 1936, ordered:

1. That an investigation pursuant to the provisions of Section 337 of the Tariff Act of 1930 be instituted into alleged unfair methods of competition or unfair acts in violation of said section in the importation or sale in the United States of cigar lighters made in accordance with the terms of United States Letters Patent Nos. 1,986,384, 2,002,845 and Des. 96,639 or in simulation of such lighters.

2. That notice be, and the same is hereby, given to Atlantic & Pacific Merchandise Co., 876 Broadway; Henry Amdur & Sons, Inc., 325 Fifth Avenue; and National Silver Co., 61 West 23rd Street, all in New York City; Homer's, Inc., Boston, Mass.; and Mallove's, Inc., 48 State Street, New London, Conn., and to all other persons, partnerships, associations, and corporations concerned as owners, importers, consignees, agents, or otherwise in the alleged unfair methods of competition or unfair acts in the importation

[1] 1 F. R. 976.

or sale of said products, and that they, and each of them, will be afforded opportunity to make written answer under oath and file said *answer* in quadruplicate with the Commission on or before the 15th day of December 1936, and show cause, if any they have, why the provisions of Section 337 of the Tariff Act of 1930 should not be applied in respect of said alleged unfair methods of competition or unfair acts in the importation or sale of said products.

3. That a *public hearing* in said investigation be held at the office of the United States Tariff Commission, Washington, D. C., at 10 o'clock a. m., on the 7th day of January 1937, at which hearing the said complainant and respondents and all other persons, partnerships, associations, and corporations concerned as owners, importers, consignees, agents, or otherwise, in the alleged unfair methods of competition and unfair acts in the importation or sale of said products will be afforded opportunity to be present, to produce evidence, and to be heard concerning said alleged unfair methods of competition and unfair acts in the importation or sale of said products constituting the subject matter of this investigation.

4. That public notice of said investigation, and of time for filing answers and of public hearing shall be given by publishing the text of this notice in Treasury Decisions, published by the Department of the Treasury, and by announcement thereof in Commerce Reports, published by the Department of Commerce, copies of which said publications are obtainable from the Superintendent of Documents, Government Printing Office, Washington, D. C., also by posting a copy of this notice for 30 days prior to said 7th day of January 1937 at the principal office of the Tariff Commission in the city of Washington, D. C., and at the office of the Tariff Commission at the port of New York.

5. That notice of said investigation, of time for answers, and of public hearing shall also be given by mailing registered, postage prepaid, a copy of this notice to the complainant herein, and by mailing registered, postage prepaid, a copy of this notice, together with a copy of the complaint, to the respondents named herein.

I hereby certify that the foregoing investigation was ordered by the United States Tariff Commission on August 14, 1936.

[SEAL] SIDNEY MORGAN, *Secretary*.

[F. R. Doc. 3370—Filed, November 12, 1936; 3:49 p. m.]