FEDERAL REGISTER

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Rules, Regulations, Orders

TITLE 7—AGRICULTURE

CHAPTER V—FEDERAL SURPLUS COMMODITIES CORPORATION

AMENDMENT TO (1) REGULATIONS AND CONDITIONS GOVERNING THE ISSUANCE OF FOOD ORDER STAMPS, ESTABLISHING THE ELIGIBILITY OF THE HOLDERS THEREOF TO RECEIVE AGRICULTURAL COMMODITIES OR THE PRODUCTS THEREOF AND PROVIDING FOR THE PAYMENT OF CLAIMS MADE BY RETAILERS OF SUCH COMMODITIES AND PRODUCTS, AS AMENDED, AND (2) REGULATIONS AND CONDITIONS GOVERNING THE ISSUANCE OF FOOD ORDER STAMPS TO PERSONS IN LOW INCOME GROUPS IN SHAWNEE, OKLAHOMA, ESTABLISHING THE ELIGIBILITY OF THE HOLDERS THEREOF TO RECEIVE AGRICULTURAL COMMODITIES OR THE PRODUCTS THEREOF, AND PROVIDING FOR THE PAYMENT OF CLAIMS MADE BY RETAILERS OF SUCH COMMODITIES AND PRODUCTS, AS AMENDED

Sections 100 and 300 (c) of the "Regulations and Conditions Governing the Issuance of Food Order Stamps Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Secretary of Agriculture on April 21, 1939, as amended,[1] and Sections 100 (c) and 201 (6) of the "Regulations and Conditions Governing the Issuance of Food Order Stamps to Persons in Low Income Groups in Shawnee, Oklahoma, Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Acting Secretary of Agriculture on October 14, 1939,[1] as amended are hereby further amended as follows:

(1) Section 100 of the "Regulations and Conditions Governing the Issuance of Food Order Stamps Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Secretary of Agriculture on April 21, 1939, as amended, is hereby amended by striking the period at the end of the first sentence thereof and inserting in lieu thereof the following:

"*Provided, however,* That whenever the Corporation shall deem it desirable to do so in order to effect the food distribution plan, it may issue orange colored and blue surplus food order stamps or blue surplus food order stamps only, to duly authorized agencies for, and on behalf of, persons or classes of persons who in the judgment of the Corporation require such public assistance."

(2) Section 100 of the "Regulations and Conditions Governing the Issuance of Food Order Stamps Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Secretary of Agriculture on April 21, 1939, as amended, and Section 201 (6) of the "Regulations and Conditions Governing the Issuance of Food Order Stamps to Persons in Low Income Groups in Shawnee, Oklahoma, Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Acting Secretary of Agriculture on October 14, 1939, as amended, are hereby amended by striking out the second sentence of the former and the first sentence of the latter and substituting in lieu thereof the following:

"After the issuance of the second book or series of books of food order stamps to any eligible person, no book or series of books shall be issued to such persons unless such person executes such certification relative to the use of each book

[1] 4 F.R. 4942 DI.

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FEDERAL REGISTER

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of food order stamps as the Corporation may require or there has been turned in to the issuing officer the covers of the initial book or series of books together with the proper certification of the holder provided for thereon. If the Corporation requires the return of the covers of books of food order stamps, except as hereinafter provided no holder shall be eligible to receive further books unless he has in like manner, with like certification turned in the covers of all books previously issued, except the last book or series of books immediately preceding."

(3) Section 300 (c) of the "Regulations and Conditions Governing the Issuance of Food Order Stamps Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Secretary of Agriculture on April 21, 1939, as amended, and Section 100 (c) of the "Regulations and Conditions Governing the Issuance of Food Order Stamps to Persons in Low Income Groups in Shawnee, Oklahoma, Establishing the Eligibility of the Holders Thereof to Receive Agricultural Commodities or the Products Thereof and Providing for the Payment of Claims Made by Retailers of Such Commodities and Products" made and prescribed by the Acting Secretary of Agriculture on October 14, 1939, as amended, are hereby amended by striking the period and inserting in lieu thereof the following:

"or in such other food or grocery products, as, in the judgment of the Corporation, will effectuate the food distribution plan."

In testimony whereof, I have hereunto set my hand and caused the official seal of the Department of Agriculture to be affixed hereto, in the City of Washington, this 31st day of January 1940.

[SEAL] H. A. WALLACE,
Secretary of Agriculture.

Effective Date, February 14, 1940.

[F. R. Doc. 40-480; Filed, January 31, 1940; 12:31 p. m.]

TITLE 9—ANIMALS AND ANIMAL PRODUCTS

CHAPTER II—AGRICULTURAL MARKETING SERVICE

NOTICE UNDER PACKERS AND STOCKYARDS ACT [1]

JANUARY 31, 1940.

To Mr. GEORGE H. TURNER,
doing business as Yuma Livestock Auction, Yuma, Colo.

Whereas, the Yuma Livestock Auction, at Yuma, Colorado, was posted on Sept. 28, 1937, as a stockyard subject to the provisions of the Packers and Stockyards Act, 1921; and

Whereas, it now appears that the Yuma Livestock Auction is not being operated as a stockyard within the meaning of that term as defined in said Act:

Now, therefore, notice is hereby given that the Yuma Livestock Auction, at Yuma, Colorado, no longer comes within the foregoing definition and the provisions of Title III of said Act.

[SEAL] GROVER B. HILL,
Assistant Secretary of Agriculture.

[F. R. Doc. 40-479; Filed, January 31, 1940; 12:31 p. m.]

TITLE 26—INTERNAL REVENUE

CHAPTER I—BUREAU OF INTERNAL REVENUE

[Regulations 103]

INCOME TAX UNDER THE INTERNAL REVENUE CODE*

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[1] Modifies list posted stockyards 9 CFR 204.1.

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Mutual Investment Companies

Pertinent Enacting Provisions of the Internal Revenue Code [1]

AN ACT

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

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

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

* * * * *

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

* * * * *

SUBPART A—INTRODUCTORY PROVISIONS

SEC. 1. APPLICATION OF CHAPTER.

The provisions of this chapter shall apply only to taxable years beginning after December 31, 1938. Income, war-profits, and

[1] Act February 10, 1939, 53 Stat., Part 1.

excess-profits taxes for taxable years beginning prior to January 1, 1939, shall not be affected by the provisions of this chapter, but shall remain subject to the applicable provisions of the Revenue Act of 1938 and prior revenue acts, except as such provisions are modified by legislation enacted subsequent to the Revenue Act of 1938.

§ 19.1–1 *Scope of regulations.* These regulations deal with the taxes upon net income imposed by chapter 1 of the Internal Revenue Code, including the tax imposed by section 102 upon the net income of certain corporations, and with the surtax imposed by subchapter A of chapter 2 (sections 500 to 511, inclusive) upon the undistributed subchapter A net income of personal holding companies. Each section, subsection, or paragraph of the Internal Revenue Code set forth in these regulations shall be considered as a part of the respective regulations section to which it corresponds.*

SEC. 2. CROSS REFERENCES.

The cross references in this chapter to other portions of the chapter, where the word "see" is used, are made only for convenience, and shall be given no legal effect.

SEC. 3. CLASSIFICATION OF PROVISIONS.

The provisions of this chapter are herein classified and designated as—

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

§ 19.3–1 *Division of regulations.* These regulations, which constitute Part 19 of Title 26 of the 1940 Supplement to the Code of Federal Regulations, are divided into six subparts. Subpart A relates to Introductory Provisions. Subpart B relates to General Provisions. Subpart C relates to Supplemental Provisions. Subpart D relates to Surtax on Personal Holding Companies. Subpart E relates to Definitions. Subpart F relates to Mitigation of Effect of Limitation and Other Provisions in Income Tax Cases.*

SEC. 4. SPECIAL CLASSES OF TAXPAYERS.

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

(a) Estates and trusts and the beneficiaries thereof,—Supplement E.
(b) Members of partnerships,—Supplement F.
(c) Insurance companies,—Supplement G.
(d) Nonresident alien individuals,—Supplement H.
(e) Foreign corporations,—Supplement I.
(f) Individual citizens of any possession of the United States who are not otherwise citizens of the United States and who are not residents of the United States,—Supplement J.
(g) Individual citizens of the United States or domestic corporations, satisfying the conditions of section 251 by reason of deriving a large portion of their gross income from sources within a possession of the United States,—Supplement J.
(h) China Trade Act corporations,—Supplement K.
(i) Foreign personal holding companies and their shareholders,—Supplement P.
(j) Mutual investment companies—Supplement.[3]

[3] So in original. "Supplement Q" evidently intended.

No. 22——2

§ 19.4–1 *Application of regulations to special classes of taxpayers.* With respect to certain classes of taxpayers, the application of the provisions of Subpart B of these regulations is subject to certain exceptions and additional provisions, which appear in Subpart C, as follows:

Estates and trusts—sections 161 to 170, inclusive.
Partnerships—sections 181 to 189, inclusive.
Insurance companies—sections 201 to 208, inclusive.
Nonresident alien individuals—sections 211 to 219, inclusive.
Foreign corporations—sections 231 to 238, inclusive.
Income from sources in possessions of the United States—sections 251 and 252.
China Trade Act corporations—sections 261 to 265, inclusive.
Foreign personal holding companies—sections 331 to 340, inclusive.
Mutual investment companies—sections 361 and 362.*

SUBPART B.—GENERAL PROVISIONS

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.

§ 19.11–1 *Income tax on individuals.* Chapter 1 of the Internal Revenue Code, which applies only to taxable years beginning after December 31, 1938 (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 to 24, inclusive.) In certain cases credits are allowed against the net income before computing the tax (section 25) and in other cases against the amount of the tax (sections 31, 32, and 131). In general, the tax is payable upon the basis of returns rendered by persons liable thereto (sections 51, 53, 142, and 217), except that in some instances it is to be paid at the source of the income (section 143). Exceptions and additional provisions applicable to certain special classes of taxpayers are listed in section 4.

See Supplement P (sections 331 to 340, inclusive) as to shareholders of foreign personal holding companies. See section 117 as to the treatment of capital gains and capital losses.*

§ 19.11–2 *Citizens or residents of the United States liable to tax.* In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. As to nonresident alien individuals, see sections 211 to 219, inclusive.*

§ 19.11–3 *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 sections 19.211–2 to 19.211–5, inclusive, 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 $250,00, 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 of 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 in case of capital gains or losses.* For rate and computation of alternative tax in lieu of normal tax and surtax in the case of capital gain or loss from the sale or exchange of capital assets held for more than eighteen months, see section 117 (c).

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

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

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

§ 19.12–1 *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 sections 19.25–1 to 19.25–7, inclusive.) For surtax on corporations improperly accumulating surplus see section 102. As to surtax on personal holding companies, see sections 500 to 511, inclusive.*

§ 19.12–2 *Computation of surtax.* The following table shows the surtax due for taxable years beginning after December 31, 1938, 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
$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 stated in round figures in the table is computed by adding to the surtax for the largest amount stated which is less than the surtax net income, the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax due for taxable years beginning after December 31, 1938, 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. TAX ON CORPORATIONS IN GENERAL.

(a) *Adjusted net income.* For the purposes of this chapter the term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

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

(c) *General rule.* The tax computed under this subsection shall be as follows:

(1) A tentative tax shall first be computed equal to 19 per centum of the adjusted net income.

(2) The tax shall be the tentative tax reduced by the sum of—

(A) 16½ per centum of the credit for dividends received provided in section 26 (b); and

(B) 2½ per centum of the dividends paid credit provided in section 27, but not to exceed 2½ per centum of the adjusted net income.

(d) *Alternative tax (corporations with net income slightly more than $25,000).*

(1) If no portion of the gross income consists of interest allowed as a credit by section 26 (a) (relating to interest on certain obligations of the United States and Government corporations), or of dividends of the class with respect to which credit is allowed by section 26 (b), then the tax computed under this subsection shall be equal to $3,525, plus 32 per centum of the amount of the net income in excess of $25,000.

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

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

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

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

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

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

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

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

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

(f) *Joint-stock land banks.* In the case of a joint-stock land bank organized under the Federal Farm Loan Act, 39 Stat. 360, 42 Stat. 1454 (U.S.C. Title 12, § 641), as amended, when the tax is computed under subsection (c), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit.

(g) *Rental housing corporations.* In the case of a corporation which at the close of the taxable year is regulated or restricted by the Federal Housing Administrator under section 207 (b) (2) of the National Housing Act, as amended, 52 Stat. 17, when the tax is computed under subsection (c), the tentative tax shall be reduced by 2½ per centum of the adjusted net income, instead of by 2½ per centum of the dividends paid credit; but only if such Administrator certifies to the Commissioner the fact that such regulation or restriction existed at the close of the taxable year. It shall be the duty of such Administrator promptly to make such certification to the Commissioner after the close of the taxable year of each corporation which is so regulated or restricted by him.

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

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

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

SEC. 201. CORPORATION TAX IN GENERAL. (REVENUE ACT OF 1939.)

Sections 13 * * * of the Internal Revenue Code are amended to read as follows:

"SEC. 13. TAX ON CORPORATIONS IN GENERAL.

"(a) *Definitions.* For the purposes of this chapter—

"(1) *Adjusted net income.* The term 'adjusted net income' means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

"(2) *Normal-tax net income.* The term 'normal-tax net income' means the adjusted net income minus the credit for dividends received provided in section 26 (b).

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

"(1) *General rule.* A tax of 18 per centum of the normal-tax net income; or

"(2) *Alternative tax (corporations with normal-tax net income slightly more than $25,000).* A tax of $3,525, plus 32 per centum of the amount of the normal-tax net income in excess of $25,000.

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

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

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

* * * * *

SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

SEC. 19.13–1 *Tax on corporations in general—Taxable years beginning in 1939.* Section 13, prior to its amendment, and sections 19.13–1 to 19.13–4, inclusive, are applicable only with respect to taxable years beginning after December 31, 1938, and before January 1, 1940 (see section 15 and section 19.15–1). For provisions for income taxes on corporations in general applicable with respect to taxable years beginning after December 31, 1939, see section 13, as amended, and sections 19.13–5 to 19.13–7, inclusive.

For any taxable year beginning after December 31, 1938, and before January 1, 1940, section 13, prior to its amendment, imposes an income tax on corporations in general the net income of which is more than $25,000. Every such corporation is liable to the tax imposed by such section, except (1) corporations expressly exempt from taxation under chapter 1 (see section 101); (2) corporations subject to tax under section 14, prior to its amendment, being (A) corporations having net incomes of not more than $25,000 and not coming within one of the classes specified in subsection (d), (e), (f), or (g) of such section 14, (B) banks, as defined in section 104, (C) corporations organized under the China Trade Act, 1922, (D) corporations which by reason of deriving a large portion of their gross income from sources within a possession of the United States are entitled to the benefits of section 251, and (E) foreign corporations engaged in trade or business within the United States or having an office or place of business therein; (3) foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein (see section 231 (a)); (4) insurance companies (see sections 201 to 207, inclusive, of Supplement G); and (5) mutual investment companies (see Supplement Q (sections 361 and 362)).

It makes no difference that a domestic corporation subject to any tax imposed by section 13, prior to its amendment, may derive no income from sources within the United States. The tax imposed by such section is computed upon the "adjusted net income," that is, the net income as defined in section 21 minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities. The term "adjusted net income" is used elsewhere in the regulations under chapter 1 and where so used has the meaning here given to it.

The tax is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 3797. For surtax on personal holding companies, see sections 500 to 511, inclusive. For surtax on corporations improperly accumulating surplus, see section 102.

The tax imposed shall be computed under subsection (c) (the general rule) or subsection (d) (the alternative tax) of section 13, prior to its amendment, whichever computation produces the lesser tax. Subsection (d), sometimes referred to as the "notch" provision, is designed primarily for corporations having net incomes of slightly more than $25,000. In the case of such corporations, subsection (d) will frequently produce a lesser tax, although the result in any given case depends upon the facts and figures involved (see section 19.13–3).*

§ 19.13–2 *Tax under general rule—Taxable years beginning in 1939.* Subsection (c) of section 13, prior to its amendment, provides (for any taxable year beginning after December 31, 1938, and before January 1, 1940) for the tax computation under what is termed the "general rule." A tentative tax is first computed upon the adjusted net income at the rate of 19 percent. Two credits are allowed against this tentative tax. The more important of these credits, in the majority of cases, is the one which allows a reduction in the tentative tax by 2½ percent of the dividends paid credit provided for in section 27. However, this credit may not be allowed in excess of 2½ percent of the adjusted net income. For definition of the term "dividends paid credit" and computation thereof, see section 19.27 (a)–1. The other credit allowed against the tentative tax is computed by taking 16½ percent of the credit for dividends received as described in section 26 (b), relating to dividends received from domestic corporations.

The application of the general rule set out in subsection (c) of section 13, prior to its amendment, may be illustrated by the following example:

Example. The A Corporation, a domestic corporation, which is not a bank affiliate referred to in section 26 (d), has for the calendar year 1939 a net income of $110,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of

$10,000 and dividends received (of the class allowable as a credit under section 26 (b)) in the amount of $10,000. The corporation pays to its shareholders, during the taxable year, $30,000 in dividends. It is not entitled to any dividend carry-over under section 27. Its tax for the calendar year 1939 is $17,097.50, computed as follows:

Computation of Tax

Tentative tax:			
Net income	$110,000		
Less credit for interest on United States obligations	10,000		
Adjusted net income	100,000		
Tentative tax under section 13 (c) (19 percent of $100,000)			$19,000.00
Credits on account of dividends received and dividends paid:			
(1) Dividends received (85 percent of $10,000×16½ percent)		$1,402.50	
(2) Dividends paid ($30,000—$10,000 × 2½ percent)		500.00	
Total credit (section 13 (c) (2))			1,902.50
Total tax			17,097.50

S53. 19.13-3 *Alternative tax (corporations with net incomes slightly more than $25,000)—Taxable years beginning in 1939.* Subsection (d) of section 13, prior to its amendment, provides an alternative method for computing the tax (for any taxable year beginning after December 31, 1938, and before January 1, 1940) in the case of corporations having net incomes of slightly more than $25,000. If no portion of the gross income consists of interest on obligations of the United States and its instrumentalities allowable as a credit under section 26 (a), or of dividends of the class with respect to which the credit is allowable under section 26 (b), the alternative tax is equal to $3,525 plus 32 percent of the amount of the net income in excess of $25,000. If any portion of the gross income consists of interest or dividends referred to in the preceding sentence, it is necessary, in order to determine the amount of net income subject to tax and the rate of tax applicable thereto, first to divide the income into two parts, or divisions, the first division consisting of $25,000 and the second division consisting of the balance of the net income in excess of $25,000.

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

Example (1). The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1939 a net income of $34,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $15,000 and dividends received (of the class allowable as a credit under section 26 (b) in the amount of $12,000. It is not entitled to a dividends paid credit under section 27. Since, as will hereinafter appear, the alternative tax is more than the tax computed under the general rule, the correct tax is the tax computed under the general rule, that is, $1,927. The tax is computed as follows:

Tax Under General Rule

Net income	$34,000.00
Less interest on United States obligations	15,000.00
Adjusted net income	19,000.00
Tentative tax (19 percent of ($19,000)	3,610.00
Less credit for dividends received (16½ percent of 85 percent of $12,000)	1,683.00
Total tax under general rule	1,927.00

Alternative Tax

Total net income	$34,000.00
Less net income allocated to first division	25,000.00
Net income allocated to second division	9,000.00
Tax on first division:	
Total net income	25,000.00
Less interest on United States obligations	15,000.00
Adjusted net income	10,000.00
Less credit for dividends received (85 percent of $10,000)	8,500.00
Special class net income (section 14(a))	1,500.00
Tax under section 14 (12½ percent of $1,500)	187.50
Tax on second division:	
Total income allocated to second division	9,000.00
Less dividends received allocated to second division	2,000.00
Ordinary income	7,000.00
Tax:	
(12 percent of $2,000)	240.00
(32 percent of $7,000)	2,240.00
Total tax on second division	2,480.00
Total alternative tax:	
Tax on first division	187.50
Tax on second division	2,480.00
Total alternative tax	2,667.50

Example 2. The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1939 a net income of $27,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $10,000, but no dividends of the class allowable as a credit under section 26 (b). It paid dividends during the year in the amount of $15,000. It is not entitled to any dividend carry-over under section 27. Since the alternative tax is less than the tax computed under the general rule, the correct tax is the alternative tax, that is, $2,665. The tax is computed as follows:

Alternative Tax

Allocation of income:	
First division:	
Interest on United States obligations	$10,000
Ordinary income	15,000
Total	25,000
Second division:	
Ordinary income	2,000
Total income	27,000
Tax under alternative plan:	
First division:	
12½ percent of $5,000	625
14 percent of $10,000	1,400
Total tax on first division	2,025
Tax on second division (32 percent of $2,000)	640
Total tax under alternative plan	2,665

Tax Under General Rule

Total net income	$27,000
Less interest on United States obligations	10,000
Adjusted net income	17,000
Tentative tax (19 percent of $17,000)	3,230
Less credit for dividends paid (2½ percent of $15,000—$10,000)	125
Tax	3,105

§ 19.13-4 *Corporations in bankruptcy or receivership, joint-stock land banks and rental housing corporations—Taxable years beginning in 1939.* In any case in which (for any taxable year beginning after December 31, 1938, and before January 1, 1940) the tax is computed under subsection (c) of section 13, prior to its amendment, and the taxpayer is—

(1) a domestic corporation which for any portion of the taxable year is in bankruptcy under the laws of the United States, or insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia, or

(2) a joint-stock land bank organized under the Federal Farm Loan Act, as amended, or

(3) a corporation which at the close of the taxable year is regulated or restricted by the Federal Housing Administrator under section 207 (b) (2) of the National Housing Act, as amended, and such administrator certifies to the Commissioner the fact that such regulation or restriction existed at the close of the taxable year,

then in lieu of the credit against the tentative tax as computed under such subsection (c) on account of dividends paid, there shall be allowed a credit of 2½ percent of the adjusted net income. If the net income of any such corporation (for any taxable year beginning after December 31, 1938, and before January 1, 1940) is $25,000 or less, it is taxed under section 14, prior to its amendment, and if its net income (for any such taxable year) is slightly more than $25,000, it may be subject to the alternative tax under subsection (d) of section 13, prior to its amendment.

Generally, in the case of any proceedings under the Bankruptcy Act of 1898, as amended, the corporation is in bankruptcy if it has been adjudicated bankrupt, if a petition for reorganization of the corporation has been filed by the corporation or its creditors and has been approved by the court having jurisdiction thereof, or if the corporation has filed a petition for an arrangement of its indebtedness under Chapter XI of the Act in a court having jurisdiction thereof. In such case, the provisions of subsection (e) of section 13, prior to its amendment, allowing a credit of 2½ percent of the adjusted net income, in lieu of the credit on account of dividends paid, shall not apply to—

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

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

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

(d) the debtor corporation for any taxable year (beginning after December 31, 1938, and before January 1, 1940) subsequent to the taxable year during which any of the properties dealt with by the plan either

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

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

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

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

Any corporation claiming the credit under subsection (e), (f), or (g) of section 13, prior to its amendment, that is, seeking to reduce the tentative tax by 2½ percent of the adjusted net income, instead of by 2½ percent of the dividends paid credit, shall file as a part of its return for any taxable year (beginning after December 31, 1938, and before January 1, 1940) for which such credit is claimed a statement under oath of all facts pertinent to its claim.*

§ 19.13-5 *Tax on corporations in general—Taxable years beginning after December 31, 1939.* Section 13, as amended, and sections 19.13-5 to 19.13-7, inclusive, are applicable only with respect to taxable years beginning after December 31, 1939. For provisions for income taxes on corporations in general applicable with respect to taxable years beginning after December 31, 1938, and before January 1, 1940, see section 13, prior to its amendment, and sections 19.13-1 to 19.13-4, inclusive.

For any taxable year beginning after December 31, 1939, section 13, as amended, imposes an income tax on corporations in general the normal-tax net income of which is more than $25,000. Every such corporation is liable to the tax imposed by such section, except (1) corporations expressly exempt from taxation under chapter 1 (see section 101); (2) corporations subject to tax under section 14, as amended, being (A) corporations having normal-tax net incomes of not more than $25,000 and not coming within the provisions of subsection (c), (d), or (e) of such section 14, and (B) foreign corporations engaged in trade or business within the United States or having an office or place of business therein; (3) foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein (see section 231 (a)); (4) insurance companies (see Supplement G (sections 201 to 208, inclusive)); and (5) mutual investment companies (see Supplement Q (sections 361 and 362)).

It makes no difference that a domestic corporation subject to any tax imposed by section 13, as amended, may derive no income from sources within the United States. For any taxable year beginning after December 31, 1939, the tax imposed by section 13, as amended, is computed upon the "normal-tax net income," that is, the adjusted net income minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under chapter 1 (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income).

The tax imposed by section 13, as amended, is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income (see also sections 47, 52, 53, 144, and 235). For what the term "corporation" includes and for the difference between domestic and foreign corporations, see section 3797 (a). For surtax on personal holding companies, see sections 500 to 511, inclusive. For surtax on corporations improperly accumulating surplus, see section 102.

For any taxable year beginning after December 31, 1939, the tax imposed by section 13, as amended, shall be computed under subsection (b) (1) (the general rule) or subsection (b) (2) (the alternative tax), whichever computation produces the lesser tax. Subsection (b) (2), sometimes referred to as the "notch" provision, is designed primarily for corporations having normal-tax net incomes of slightly more than $25,000. For normal-tax net incomes of $31,964.30 or more the correct tax is that computed under the general rule, since such tax will, for such incomes, always be less than the alternative tax. For normal-tax net incomes of more than $25,000 but less than $31,964.30 the correct tax is the alternative tax, since such tax will, for such incomes, always be equal to or less than the tax computed under the general rule.*

§ 19.13-6 *Tax under general rule—Taxable years beginning after December 31, 1939.* For any taxable year beginning after December 31, 1939, subsection (b) (1) of section 13, as amended, provides, under what is termed the "general rule," for a tax equal to 18 percent of the normal-tax net income. For alternative tax in the case of corporations having normal-tax net incomes of less than $31,-964.30, see section 19.13-7.

The application of such general rule may be illustrated by the following example:

Example: The A Corporation, a domestic corporation, which is not a bank affiliate referred to in section 26 (d), has for the calendar year 1940 a net income of $110,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $10,000 and dividends received (of a class allowable as a credit under section 26 (b)) in the amount of $10,000. The corporation's tax for the calendar year 1940 is $16,470, computed as follows:

Net income	$110,000
Less credit for interest on United States obligations	10,000
Adjusted net income	100,000
Less credit for dividends received (85 percent of $10,000)	8,500
Normal-tax net income	91,500
Tax under section 13 (b) (1) (18 percent of $91,500)	16,470

*

§ 19.13-7 *Alternative tax (corporations with normal-tax net incomes slightly more than $25,000)—Taxable years beginning after December 31, 1939.* For any taxable year beginning after December 31, 1939, subsection (b) (2) of section 13, as amended, provides, in the case of corporations having normal-tax net incomes of slightly more than $25,-000, for an alternative tax of $3,525, plus 32 percent of the amount of the normal-tax net income in excess of $25,000. The alternative tax is applicable in the case of corporations having normal-tax net incomes of less than $31,964.30.

This provision may be illustrated by the following example:

Example: The A Corporation, a domestic corporation (not a bank affiliate), has for the calendar year 1940 a net income of $30,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $3,000 and dividends received (of a class allowable as a credit under section 26 (b)) in the amount of $1,000. Since the alternative tax is less than the tax computed under the general rule, the correct tax is the alternative tax, that is, $3,893. The tax is computed as follows:

Alternative Tax

Net income	$30,000
Less interest on United States obligations	3,000
Adjusted net income	27,000
Less credit for dividends received (85 percent of $1,000)	850
Normal-tax net income	26,150
Amount of normal-tax net income in excess of $25,000	1,150
Tax under section 13 (b) (2) ($3,525 plus 32 percent of $1,150)	3,893

Tax Under General Rule

Normal-tax net income (computed as above)	$26,150
Tax under section 13 (b) (1) (18 percent of $26,150)	4,707

*

SEC. 14. TAX ON SPECIAL CLASSES OF CORPORATIONS.

(a) *Special class net income.* For the purposes of this chapter the term "special class net income" means the adjusted net income minus the credit for dividends received provided in section 26 (b).

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

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

Upon special class net incomes not in excess of $5,000, 12½ per centum.

$625 upon special class net incomes of $5,000, and upon special class net incomes in excess of $5,000 and not in excess of $20,000, 14 per centum in addition of such excess.

$2,725 upon special class net incomes of $20,000, and upon special class net incomes in excess of $20,000, 16 per centum in addition of such excess.

(d) *Special classes of corporations.* In the case of the following corporations the tax shall be an amount equal to 16½ per centum of the special class net income, regardless of the amount thereof:

(1) Banks, as defined in section 104.

(2) Corporations organized under the China Trade Act, 1922, (42 Stat. 849 (U. S. C., Title 15, c. 4).)

(3) 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.

(e) *Foreign corporations.*

(1) In the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein, the tax shall be an amount equal to 19 per centum of the special class net income, regardless of the amount thereof.

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

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

(g) *Mutual investment companies.* In the case of mutual investment companies, as defined in Supplement Q, the tax shall be as provided in such Supplement.

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

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

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

SEC. 201. CORPORATION TAX IN GENERAL. (REVENUE ACT OF 1939.)

Sections * * * 14 * * * of the Internal Revenue Code are amended to read as follows:

* * * * *

SEC. 14. TAX ON SPECIAL CLASSES OF CORPORATIONS.

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

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

"Upon normal-tax net incomes not in excess of $5,000, 12½ per centum.

"$625 upon normal-tax net incomes of $5,000, and upon normal-tax net incomes in excess of $5,000 and not in excess of $20,000, 14 per centum in addition of such excess.

"$2,725 upon normal-tax net incomes of $20,000, and upon normal-tax net incomes in excess of $20,000, 16 per centum in addition of such excess.

"(c) *Foreign corporations.*

"(1) In the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein, the tax shall be an amount equal to 18 per centum of the normal-tax net income, regardless of the amount thereof.

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

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

"(e) *Mutual investment companies.* In the case of mutual investment companies, as defined in Supplement Q, the tax shall be as provided in such Supplement.

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

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

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

SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

§ 19.14-1. *Tax on special corporations—Taxable years beginning in 1939.* Section 14, prior to its amendment, and this section of the regulations are applicable only with respect to taxable years beginning after December 31, 1938, and before January 1, 1940 (see section 15 and section 19.15-1). For provisions for income taxes on special classes of corporations applicable with respect to taxable years beginning after December 31, 1939, see section 14, as amended, and section 19.14-2.

For any taxable year beginning after December 31, 1938, and before January 1, 1940, section 14, prior to its amendment, imposes an income tax on (1) corporations having net incomes of not more than $25,000, (2) certain special classes of corporations and (3) certain foreign corporations. The special classes of corporations are banks, as defined in section 104, corporations organized under the China Trade Act, 1922, and 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. The tax imposed by section 14, prior to its amendment, is in lieu of the tax imposed by section 13, prior to its amendment. Corporations expressly exempt from taxation under chapter 1 (see section 101) are not subject to tax under section 14, prior to its amendment.

The tax is imposed upon the "special class net income," that is, the adjusted net income minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under chapter 1 (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income). The term "special class net income" is used elsewhere in the regulations under chapter 1 and where so used has the meaning here given it.

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

For any taxable year beginning after December 31, 1938, and before January 1, 1940, subsection (c) of section 14, prior to its amendment, imposes a tax at graduated rates on corporations which do not have net incomes of more than $25,000 and which do not come within one of the classes specified in subsection (d) (special classes of corporations), (e) (foreign corporations), (f) (insurance companies), or (g) (mutual investment companies) of such section 14. The tax is the same whether or not the corporation distributes any dividends during the taxable year.

The following table shows the income tax due, for any taxable year beginning after December 31, 1938, and before January 1, 1940, from corporations coming within the terms of subsection (c) of section 14, prior to its amendment, upon certain specified amounts of special class net income. In each instance the first figure of the special class net income in the special class net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the special class net-income column. The last column gives the total tax on a special class net income equal to the second figure in the special class net-income column.

Table of Corporation Income Tax Under Section 14 (c), Prior to Its Amendment

Special class net income	Percent	Total tax
$0 to $5,000	12½	$625
$5,000 to $20,000	14	2,725
$20,000 to $25,000	16	3,525

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

Example: The A Corporation, a domestic corporation, has for the calendar year 1939 a net income of $24,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $9,000 and dividends received (of the class allowable as a credit under section 26 (b)) in the amount of $5,000. The corporation pays to its shareholders, during the taxable year, $5,000 in dividends. The tax upon the corporation is $1,430, computed as follows:

Total net income	$24,000
Less interest on United States obligations	9,000
Adjusted net income	15,000
Deduct credit under section 26 (b) (85 percent of $5,000)	4,250
Special class net income	10,750
Tax on $5,000 at 12½ percent	625
Tax on $5,750 at 14 percent	805
Total tax	1,430

Subsection (d) of section 14, prior to its amendment, relates to (1) banks, as defined in section 104, (2) corporations organized under the China Trade Act, 1922, and (3) corporations which, by reason of deriving a large portion of their gross income from sources within possessions of the United States, are entitled to the benefits of section 251. That subsection imposes, for any taxable year beginning after December 31, 1938, and before January 1, 1940, an income tax upon such corporations in an amount equal to 16½ percent of the special class net income, regardless of the amount thereof.

For any taxable year beginning after December 31, 1938, and prior to January 1, 1940, subsection (e) of section 14, prior to its amendment, provides for a tax on foreign corporations engaged in trade or business within the United States or having an office or place of business therein, equal to 19 percent of the special class net income, regardless of the amount thereof. In the case of foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, the tax is as provided in section 231 (a). In the case of insurance companies, the tax is as provided in sections 201 to 207, inclusive, of Supplement G. In the case of mutual investment companies, as defined in Supplement Q (sections 361 and 362), the tax is as provided in Supplement Q.*

§ 19.14-2 *Tax on special corporations—Taxable years beginning after December 31, 1939.* Section 14, as amended, and this section of the regulations are applicable only with respect to taxable years beginning after December 31, 1939. For provisions for income taxes on special classes of corporations applicable with respect to taxable years beginning after December 31, 1938, and before January 1, 1940, see section 14, prior to its amendment, and section 19.14-1.

For any taxable year beginning after December 31, 1939, section 14, as amended, imposes an income tax upon (1) corporations having normal-tax net incomes of not more than $25,000, and (2) certain foreign corporations. The tax imposed by section 14, as amended, is in lieu of the tax imposed by section 13, as amended. The tax is imposed upon the "normal-tax net income," for the definition of which see section 13, as amended, and section 19.13-5. Corporations expressly exempt from taxation under chapter 1 (see section 101) are not subject to tax under section 14, as amended.

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

For any taxable year beginning after December 31, 1939, subsection (b) of section 14, as amended, imposes a tax at graduated rates on corporations which do not have normal-tax net incomes of more than $25,000 and which do not come within one of the classes specified in subsection (c) (foreign corporations), (d) (insurance companies), or (e) (mutual investment companies) of such section 14. The tax is the same whether or not the corporation distributes any dividends during the taxable year.

The following table shows the income tax due, for any taxable year beginning after December 31, 1939, from corporations coming within the terms of subsection (b) of section 14, as amended, upon certain specified amounts of normal-tax net income. In each instance the first figure of the normal-tax net income in the normal-tax net-income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the normal-tax net-income column. The last column gives the total tax on a normal-tax net income equal to the second figure in the normal-tax net-income column.

Table of Corporation Income Tax Under Section 14 (c), as Amended

Normal-tax net income	Per-cent	Total tax
$0 to $5,000	12½	$625
$5,000 to $20,000	14	2,725
$20,000 to $25,000	16	3,525

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

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

Example: The A Corporation, a domestic corporation, has for the calendar year 1940 a net income of $24,000, including interest on United States obligations (allowable as a credit under section 26 (a)) in the amount of $9,000, and dividends received (of the class allowable as a credit under section 26 (b)) in the amount of $5,000. The tax upon the corporation is $1,430, computed as follows:

Net income	$24,000
Less interest on United States obligations	9,000
Adjusted net income	15,000
Less credit for dividends received (85 percent of $5,000)	4,250
Normal-tax net income	10,750
Tax on $5,000 at 12½ percent	625
Tax on $5,750 at 14 percent	805
Total tax	1,430

For any taxable year beginning after December 31, 1939, subsection (c) of section 14, as amended, provides for a tax on foreign corporations engaged in trade or business within the United States or having an office or place of business therein, equal to 18 percent of the normal-tax net income, regardless of the amount thereof. In the case of foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, the tax is as provided in section 231 (a). In the case of insurance companies the tax is as provided in Supplement G (sections 201 to 208, inclusive). In the case of mutual investment companies, as defined in Supplement Q (sections 361 and 362), the tax is as provided in such Supplement.*

SEC. 15. CORPORATE TAXES EFFECTIVE FOR TWO TAXABLE YEARS.

The taxes imposed by section 13, section 14 (except subsection (e) (2)), Supplement G, or Supplement Q, of this chapter, or by section 13, section 14, or Supplement G of the Revenue Act of 1936, shall not apply to any taxable year beginning after December 31, 1939.

§ 19.15-1 *Purpose and effect of section 15.* The taxes imposed by section 13, section 14 (except subsection (e) (2)), Supplement G (sections 201 to 207, inclusive), or Supplement Q (sections 361 and 362), prior to the amendment of such provisions, and the taxes imposed by section 13, section 14, or Supplement G of the Revenue Act of 1936 are temporary, since, under section 15, they are not applicable with respect to taxable years beginning after December 31, 1939.

The taxes imposed by section 13, section 14, Supplement G (sections 201 to 208, inclusive), or Supplement Q (sections 361 and 362), as such provisions are amended, are applicable with respect to taxable years beginning after December 31, 1939. Section 15 has no effect whatsoever with respect to such taxes, but serves only to limit the operation of the taxes imposed by the provisions mentioned in the preceding paragraph.*

Computation of Net Income

SEC. 21. NET INCOME.

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

(b) *Cross references.* For definition of "adjusted net income", see section 13 (a); for definition of "special class net income", see section 14 (a).

SEC. 210. TECHNICAL AMENDMENTS MADE NECESSARY BY CHANGE IN CORPORATION TAX. (REVENUE ACT OF 1939.)

(a) Section 21 (b) of the Internal Revenue Code is amended to read as follows:

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

* * * * *

SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

§ 19.21-1 *Meaning of net income.* The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered.

(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the Internal Revenue Code recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22, 23, 24, and 117.)

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

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

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

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

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

SEC. 22. GROSS INCOME.

(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.

SEC. 1. PUBLIC SALARY TAX ACT OF 1939 (APPROVED APRIL 12, 1939).

Section 22 (a) of the Internal Revenue Code (relating to the definition of "gross income") is amended by inserting after the words "compensation for personal service" the following: ("including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing)".

SEC. 3. PUBLIC SALARY TAX ACT OF 1939 (APPROVED APRIL 12, 1939).

Section 22 (a) of the Internal Revenue Code is amended by adding at the end thereof a new sentence to read as follows: "In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income".

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

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see section 19.22 (a)-8.

The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. As to the amount of income tax paid for a bondholder by the obligor pursuant to a so-called tax-free covenant, see section 143 (a) (3). As to the determination of gain or loss from the sale or other disposition of property, see sections 111 to 113, inclusive. As to amounts received as loans from the Commodity Credit Corporation, see section 123.

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

§ 19.22 (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. As used in this section the term "Federal officers and employees" includes all judges of courts of the United States irrespective of when they took office. Compensation received for services rendered as an officer or employee (including a member of a legislative body and a judge or officer of a court) of a State or any political subdivision thereof, or any agency of instrumentality of any one or more of the foregoing, is to be included in gross income, regardless of the nature of the office or employment.*

§ 19.22 (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 to the commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Army, Navy, Coast Guard, Coast and Geodetic Survey, and Public Health Service, or amounts received by them as commutation of quarters, are to be excluded from gross income. (See also section 22 (b) (6).) Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees. (See section 19.24-3.) *

§ 19.22 (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.*

§ 19.22 (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 section 19.23 (m)-1 (f).*

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

§ 19.22 (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 section 19.22 (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 section 19.41-2), 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 sections 19.23 (a)-11, 19.23 (e)-5, and 19.23 (l)-10.)*

§19.22 (a)-8. *Sale of stock and rights.* If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock. In the determination of the earliest purchases of stock the rules prescribed in paragraphs (1), (2), (3), (4), and (5) of section 117 (h) (relating to the period for which property has been held) shall be applied. The excess of the amount realized on the sale over the cost or other basis of the stock will constitute gain. With respect to the basis for determining gain or loss from the sale or other disposition of stock acquired as a stock dividend or the stock with respect to which the stock dividend was acquired, see sections 19.113 (a) (19)-1 and 19.113 (a) (19)-2. If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.

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

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

Example: A taxpayer in 1934 purchased 500 shares of common stock at $125 a share, and in 1939, by reason of the ownership of such stock, acquired 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were acquired had a fair market value of $120, and the rights had a fair market value of $3 each. Instead of subscribing to the additional shares, he sold the rights at $4 each. The profit is computed as follows:

500 (shares) × $125	= $62,500, cost of old stock (stock in respect of which the rights were acquired)
500 (shares) × $120	= $60,000, market value of old stock
500 (rights) × $3	= $1,500, market value of rights
$\frac{60,000}{61,500}$ of $62,500	= $60,975.61, cost of old stock apportioned to such stock.
$\frac{1,500}{61,500}$ of $62,500	= $1,524.39, cost of old stock apportioned to rights

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

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

(2) If the shareholder exercises his rights to subscribe, the basis for determining gain or loss from a subsequent sale of a share of the stock in respect of which the rights were acquired shall be determined as in paragraph (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, properly adjusted, of the old shares assigned to the rights, plus the subscription price of the new shares, by the number of new shares acquired.

Example: A taxpayer in 1936 purchased 500 shares of common stock at $125 a share, and in 1939, by reason of the ownership of such stock, acquired 500 rights entitling him to subscribe to 100 additional shares of such stock at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were acquired had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows:

$1,524.39 (cost of old stock apportioned to rights pursuant to the computation in the example under paragraph (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 acquired is $60,975.61÷500, or $121.95 a share.

(3) If the stock in respect of which the rights are acquired was purchased at different times or at different prices and the identity of the lots cannot be determined, or if the stock in respect of which the rights are acquired was purchased at different times or at different prices and the stock rights acquired in respect of such stock cannot be identified as having been acquired in respect of any particular lot of such stock, the basis for determining the gain or loss from the sale or other disposition of the old shares, or the rights in cases in which the rights are sold, or from the sale or other disposition of the old or new shares in cases in which the rights are exercised, shall be ascertained in accordance with the principles laid down in section 19.113 (a) (12)-1.

As to deductions for losses from sales or exchanges of stocks or bonds, including losses from sales or exchanges of rights to subscribe to stock, see section 19.23 (e)-1.*

§ 19.22 (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 sections 19.111-1, 19.113 (a) (14)-1, and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive.*

§ 19.22 (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 sections 19.111-1, 19.113 (a) (14)-1, and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive.) If specific payment was not made for good will there can be no deductible loss with respect thereto, but gain may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or other basis of the good will sold.*

§ 19.22 (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.*

§ 19.22 (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 section 19.22 (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.*

§ 19.22 (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).)*

§ 19.22 (a)-14 *Cancellation of indebtedness.*

(a) *In general.* The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See section 19.22 (a)-18.) In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

For exclusion from gross income of income attributable to discharge of indebtedness of a corporation in an unsound financial condition, see section 19.22 (b) (9)-1.

(b) *Proceedings under Bankruptcy Act.* Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

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

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

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

(4) a "wage earner's plan" confirmed under Chapter XIII or the Bankruptcy Act, as amended; or

(5) a plan of adjustment confirmed under Chapter XV of the Bankruptcy Act, as amended.

If, however, such plan of corporate reorganization or agreement of composition referred to in (1) to (4) above had for one of its principal purposes the avoidance of income tax, the cancellation or reduction of indebtedness, under such plan or agreement confirmed under section 12, 74, or 77B or under Chapter X, XI, XII, or XIII of the Bankruptcy Act, as amended, may result in the realization of income. (See paragraphs 3 to 16, inclusive, of the Appendix to these regulations.)

For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness required by the Bankruptcy Act, as amended, see section 19.113 (b) (1)-2.*

§ 19.22 (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.*

§ 19.22 (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 Internal Revenue Code.*

§ 19.22 (a)-17 *Contributions to corporation by shareholders.* If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See sections 19.22 (a)-14 and 19.24-2.)*

§ 19.22 (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.

For exclusion from gross income of income attributable to discharge of indebtedness of a corporation in an unsound financial condition, see section 19.22 (b) (9)-1.*

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

§ 19.22 (a)-20 *Income to lesser 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.*

§ 19.22 (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 section 19.44-5. (See further section 19.52-2.)*

[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 chapter:

§ 19.22 (b)-1 *Exemptions—Exclusions from gross income.* Certain items of income specified in section 22 (b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government; (2) those items of income which are exempt from tax on income under the provisions of any Act of Congress still in effect; and (3) the income exempted under the provisions of section 116. Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the Internal Revenue Code to be made from gross income in computing net income. As to other items not to be included in gross income, see sections 112 and 119 and Supplements G, H, I, and J (sections 201 to 252, inclusive). Section 607 (f) of the Merchant Marine Act of 1936, as amended by section 28 of the Act of June 23, 1938 (52 Stat. 961), and changed to section 607 (h), reads as follows:

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

[SEC. 22. GROSS INCOME.]

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

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

§ 19.22 (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 section, except that the number of years to be used in the specified computation will be determined by the life expectancy of the beneficiary, as calculated by the table of mortality used by the particular insurance company in determining the amount of the annuity.

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

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

[SEC. 22. GROSS INCOME.]

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

(2) *Annuities, etc.* Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in

gross income. Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph;

§ 19.22 (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.*

§ 19.22 (b) (2)-2 *Annuities.* Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semiannually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. Such portion of each installment payment of an annuity shall be included in gross income as is not in excess of 3 percent of the aggregate premiums or consideration paid for such annuity, whether or not paid during the taxable year, divided by 12 and multiplied by the number of months in respect of which the installment is paid. As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. The provisions of this section may be illustrated by the following examples:

Example (1). A bought in 1936, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1939 he would be required to include in gross income $1,500 of the $5,000 received during that year (3 percent of $50,000), $3,500 being exempt. If A should live long enough to receive as exempt $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

Example (2). A bought an annuity on October 1, 1939, paying $100,000 as consideration therefor. The annuity amounts to $7,824 a year, payable in semiannual installments of $3,912, and on December 1, 1939, A received $1,304, the first payment under the contract being for a 2-month period. A shall include in his gross income for the calendar year 1939 the sum of $500, being 3 percent of $100,000 (the consideration paid) divided by 12 and multiplied by 2 (the number of months in respect of which the installment was paid).

Example (3). A bought an increasing annuity on August 1, 1939, paying $40,000 as consideration therefor. The annuity amounts to $1,000 a year for the first year, $2,000 a year for the second year, and $3,000 a year thereafter, payable in quarterly installments. A received the first quarterly installment on November 1, 1939, amounting to $250. A shall include in his gross income for the calendar year 1939 the sum of $250, being such portion of the installment as is not in excess of 3 percent of $40,000 (the consideration paid) divided by 12 and multiplied by 3 (the number of months in respect of which the installment was paid).*

[SEC. 22. GROSS INCOME.]

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

(3) *Gifts, bequests, 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);

§ 19.22 (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 section 19.24-1.)*

[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 chapter:]

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

§ 19.22 (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 or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.*

§ 19.22 (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), which Act was 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. Dividends on share accounts of Federal savings and loan associations are exempt from the normal tax under the provisions of section 5 (h) of the Home Owners' Loan Act of 1933 (48 Stat. 133).*

§ 19.22 (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.*

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

The interest on Treasury certificates of indebtedness is entirely exempt from Federal income taxes. Interest upon Treasury notes is exempt only to the extent provided in the terms of the issue. Interest (discount at which issued) on Treasury bills and any gain from the sale or other disposition of such bills are also entirely exempt from Federal income taxes. With respect to the nondeductibility of losses from the sale or other disposition of such bills, see section 19.23 (e)-1.

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

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

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

§ 19.22 (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.*

§ 19.22 (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 chapter:]

(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 associations;

Dividends from China Trade Act corporations;

Compensation of employees of foreign governments.

Sec. 215. Discharge of Indebtedness. (Revenue Act of 1939.)

(a) *Income from discharge of indebtedness.* Section 22 (b) of the Internal Revenue Code (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

"(9) *Income from discharge of indebtedness.* In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if—

(A) it is established to the satisfaction of the Commissioner, or

(B) it is certified to the Commissioner by any Federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal agency authorized to exercise regulatory power over such corporation,

that at the time of such discharge the taxpayer was in an unsound financial condition, and if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113 (b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term 'security' means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge occurring before the date of the enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1942."

* * * * *

(c) *Taxable years to which applicable.* The amendments made by this section shall be applicable to taxable years beginning after December 31, 1938.

§ 19.22 (b) (9)-1 *Income from discharge of indebtedness.* Section 22 (b) (9) provides a method whereby a corporation may elect to have excluded from its gross income the amount of income attributable to a discharge, within the taxable year, of its indebtedness or of indebtedness for which it is liable as, for example, in the case of a debt arising from an assumption of liability of another corporation. To be entitled to the benefits of the provisions of section

22 (b) (9) a corporation must (1) file with its return for the taxable year a consent to the provisions of the regulations, in effect at the time of the filing of the return, prescribed under section 113 (b) (3) (see sections 19.113 (b) (3)-1 and 19.113 (b) (3)-2, relating to adjustment of basis), and (2) establish that it was in an unsound financial condition immediately preceding the discharge of the indebtedness.

The existence of an unsound financial condition, for the purposes of section 22 (b) (9), may be established (1) by satisfying the Commissioner of such condition upon a presentation to him of all facts pertinent to the financial condition of the corporation or (2) by having presented to the Commissioner a certification of such condition by any Federal agency (e. g., the Reconstruction Finance Corporation) authorized to make loans to such taxpayer on behalf of the United States, or by any Federal agency (e. g., the Interstate Commerce Commission) authorized to exercise regulatory power over the taxpayer. Such a certification will be deemed to be conclusive upon the Commissioner. The certification should accompany the return.

A corporation may be in an unsound financial condition, within the meaning of section 22 (b) (9) and this section, even though the fair market value of its assets exceeds its liabilities or it is able to meet its current liabilities as they mature. Thus, highly indicative (but not conclusive) of an unsound financial condition would be the fact that bonds of the taxpayer are selling in a free market at prices substantially below their issue price and below the market price of similar issues of similar businesses.

As used in this section "indebtedness" means indebtedness evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, in existence on June 1, 1939, and issued by either the taxpayer corporation or any other corporation. Thus, for example, if a corporation obtains a discharge of its indebtedness represented only by open account book entries, section 22 (b) (9) and this section are inapplicable. If, however, a corporation obtains a discharge of its liability (evidenced by its writing) arising from an assumption of a debt of an individual or a discharge of its liability (whether or not evidenced by a writing) arising from the assumption of the indebtedness of another corporation, section 22 (b) (9) and this section are applicable.

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

The provisions of section 22 (b) (9) and this section are inapplicable in the case of any discharge occurring—(1) in a taxable year beginning before January 1, 1939; (2) before June 29, 1939; (3) in a taxable year beginning after December 31, 1942; or (4) in any proceeding under section 77B of the Bankruptcy Act of 1898, as amended, or under Chapter X, XI, or XV of such Act (see paragraphs 3 to 16, inclusive, of the Appendix to these regulations).*

§ 19.22 (b) (9)-2 *Making and filing of consent.* A consent to have the basis of its property adjusted in accordance with the provisions of the regulations, in effect at the time of filing of the return, prescribed under section 113 (b) (3) (see sections 19.113 (b) (3)-1 and 19.113 (b) (3)-2) shall be made by or on behalf of the taxpayer corporation in duplicate on Form 982, in accordance with these regulations and the instructions on the form or issued therewith. The original and duplicate shall be filed with the return.*

[SEC. 22. GROSS INCOME.]

(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.

§ 19.22 (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. (But see section 19.22 (d)-1.)*

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

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

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the 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 section 19.22 (c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22 (d). Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in section 19.41-2. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22 (d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

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

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

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

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

(3) Omitting portions of the stock on hand.

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

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

§ 19.22 (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 possession 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 section 19.22 (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 section 19.22 (c)-7), and (c) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see section 19.22 (c)-8).*

§ 19.22 (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.*

§ 19.22 (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 section 19.41-2. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.*

§ 19.22 (c)-6 *Inventories of livestock raisers and other farmers.* Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (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 for the year for which the option is exercised and for subsequent years unless another method be authorized by the Commissioner.

(1) Opening and closing inventories shall be used for the year in which the change is made. There should be included in the opening inventory all farm

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

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

(a) That if any livestock, 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 section 19.41–2. 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.*

§ 19.22 (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. See section 22 (d) as to inventories under elective method.*

§ 19.22 (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 section 19.41–2. 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) *Inventories in certain industries* [see amendment of subsection (d) by section 219 of Revenue Act of 1939, set forth below].—

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

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

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

(2) *Inventories of raw materials.* A taxpayer entitled to elect, and who has so elected, shall, in taking his inventory as of the close of any taxable year of raw materials which are—

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

(B) not yet included in goods in process or finished goods; and

(C) so intermingled that they cannot be identified with specific invoices;

treat such raw materials remaining on hand as being: First, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition.

(3) *Tanners.* A taxpayer whose principal business is tanning hides or skins, or both, shall be entitled to elect (with respect to any taxable year) the method provided in paragraph (2) as to the raw materials (including those included in goods in process and in finished goods) in the business of tanning hides, or skins, or both, if so intermingled that they cannot be identified with specific invoices.

(4) *Inventories at cost.* In the case of the application of the provisions of paragraph (2) or (3) all inventories of such materials shall be taken at cost, including the inventory as of the close of the preceding taxable year even though such preceding taxable year began prior to January 1, 1939.

(5) *Election of method.* The method provided in paragraph (2) or (3) shall not be applied unless the taxpayer, at or before the filing of his return for the preceding taxable year, has filed with the Commissioner his election to have it apply.

(6) *Regulations as to change.* The change to such method shall be made in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary to prevent the avoidance of tax.

(7) *Change to different method.* An election made under this subsection shall be irrevocable and the method so elected shall be applied in all subsequent taxable years not-

withstanding any change in the principal business of the taxpayer, unless with the approval of the Commissioner change to a different method is authorized, and then upon such terms and conditions and in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe.

SEC. 219. INVENTORIES. (REVENUE ACT OF 1939.)

(a) *Amendment to Code.* Section 22 (d) of the Internal Revenue Code (relating to inventories in certain industries) is amended to read as follows:

"(d) (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

"(A) Inventory them at cost;

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

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

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

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

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

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

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

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

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

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

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

(b) *Taxable years to which applicable.* The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

* * * * *

§19.22 (d)–1 *Inventories under elective method.* Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22 (c), and pursuant to the provisions of sections 19.22 (c)–1 to 19.22 (c)–8, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22 (d), as amended. Under this elective inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

First, those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

Second, those acquired during the taxable year.

This elective inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year beginning after December 31, 1938.

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

§ 19.22 (d)–2 *Requirements incident to adoption and use of elective method.* The adoption and use of the elective inventory method is, by section 22 (d) and regulations thereunder, made subject to the following requirements:

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

(2) The inventory shall be taken at cost regardless of market values;

(3) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand, such actual cost of the aggregate being determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year;

(4) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices, at costs determined as follows:

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

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

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

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

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

Example (1). Suppose that the taxpayer adopts the elective inventory method for the taxable year 1939 with an opening inventory of 10 units at 10 cents per unit, that it makes 1939 purchases of 10 units as follows:

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

and that it has a 1939 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(*a*) Most recent purchases—

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

or

(*b*) In order of acquisition—

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

or

(*c*) At an annual average—

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

Example (2). Suppose, in addition to the facts stated in example (1), that there is a 1940 closing inventory of 13 units. This closing inventory, being determined wholly by reference to the opening inventory, and being taken in the order of acquisition, and depending upon the taxpayer's method of valuing its inventory increase for the preceding taxable year, will be computed as follows:

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

	10 @ 10 (from 1938)	=100
	1 @ 13 (July, 1939)	= 13
	2 @ 14 (October, 1939)	= 28
Totals:	13	141

or

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

	10 @ 10 (from 1938)	=100
	1 @ 11 (January, 1939)	= 11
	2 @ 12 (April, 1939)	= 24
Totals:	13	135

or

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

	10 @ 10 (from 1938)	=100
	3 @ 13 (from 1939)	= 39
Totals:	13	139

(5) The taxpayer shall establish to the satisfaction of the Commissioner that the taxpayer has not, in the taxable year for which the elective inventory method is first used or in any subsequent taxable year, used in determining income, profit, or loss, for credit purposes, or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, any inventory method other than that referred to in section 19.22(d)-1 or at variance with the requirement referred to in paragraph (3) of this section, the taxpayer's use of market value in lieu of cost not being considered at variance with this requirement;

(6) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used, whether such preceding taxable year began before or after December 31, 1938, shall be included in the taxpayer's inventory for such preceding taxable year at cost;

(7) The elective inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

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

(b) The Commissioner determines that the taxpayer has used in ascertaining income, profits, or loss, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, and for years subsequent to his adoption of the elective inventory method, an inventory method at variance with that referred to in section 19.22 (d)-1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter; and

(8) The taxpayer shall maintain such accounting records as will enable the Commissioner readily to verify the taxpayer's inventory computations as well as his compliance with these several requirements.*

§ 19.22 (d)-3 *Time and manner of making election*. The elective inventory method may be adopted and used only if the taxpayer files with his return for the taxable year as of the close of which the method is first to be used (or, if such return is filed prior to the ninetieth day after the approval of Treasury Decision 4959, approved December 28, 1939, then at any time prior to the expiration of such ninetieth day), in triplicate on Form 970 (revised), and pursuant to the instructions printed thereon and to the requirements of this section, a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the elective method is proposed first to be used, and also as of the beginning of the preceding taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

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

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

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

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

§ 19.22 (d)-5 *Revocation of election*. An election made to adopt and use the elective inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method be required by the Commissioner, or authorized by him pursuant to a written application therefor filed with him as provided in section 19.41-2.*

§ 19.22 (d)-6 *Change from elective inventory method*. If the taxpayer is granted permission by the Commissioner to discontinue the use of the elective method of taking inventories, and thereafter to pursue some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the elective method by reason of the taxpayer's failure to conform to the requirements detailed in section 19.22 (d)-2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

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

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

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

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

[SEC. 22. GROSS INCOME.]

(e) *Distributions by corporations*. Distributions by corporations shall be taxable to the shareholders are provided in section 115.

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

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

(h) *Foreign personal holding companies*. For provisions relating to gross income of foreign personal holding companies and of their shareholders, see section 334.

(i) *Consent dividends.* For inclusion in gross income of amounts specified in shareholders' consents, see section 28.

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

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

(a) *Expenses.*

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

(2) *Corporate charitable contributions.* No deduction shall be allowable under paragraph (1) to a corporation for any contribution or gift which would be allowable as a deduction under subsection (q) were it not for the 5 per centum limitation therein contained and for the requirement therein that payment must be made within the taxable year.

§ 19.23 (a)–1 *Business expenses.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (s), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a), see section 19.23 (a)–13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See section 19.22 (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 section 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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 sections 19.23 (l)–1 to 19.23 (l)–10, inclusive.)*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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).*

§ 19.23 (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 section 19.22 (a)-13.)

In cases in which the lease contains an unexercised option of renewal, the matter of spreading such depreciation or amortization over the term of the original lease, together with the renewal period or periods, depends upon the facts in the particular case. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease or the cost of improvements shall be spread only over the number of years the lease has to run, without taking into account any right of renewal. However, if the taxpayer for any taxable year ending prior to December 31, 1939, has been allowed such depreciation or amortization on the basis of spreading the cost or other basis of such lease or improvements over the number of years the lease has to run, including any exercised or unexercised renewal period or periods, and such taxable year has been closed on that basis and the tax for that year cannot be redetermined, then the taxpayer may for subsequent taxable years take deductions on such basis if within 90 days after the approval of Treasury Decision 4957 (approved December 6, 1939) or within such later period as may be specified by the Commissioner, the files Form 969, in duplicate, with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, signifying his election to have deductions in respect of such items determined upon such basis, and expressly waives his right to claim or receive the benefits of any reduction in his tax liability which would result from the allowance of deductions for such items on the basis of only the number of years the lease has to run, without taking into account any right of renewal, or on any basis other than that set forth in his election. If, in any case, the life of the improvements is less than the number of years the lease has to run, including the renewal period if properly to be considered, the deduction for depreciation with respect to such improvements shall be spread only over such life.*

§ 19.23 (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 section 19.41-2), 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 section 19.22 (a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also sections 19.22 (a)-7, 19.23 (e)-5, and 19.23 (l)-10.)*

§ 19.23 (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.*

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

The limitations provided in section 23 (a) (2) and this section apply only to payments which are in fact contributions or gifts to organizations described in section 23 (q). For example, payments by a street railway corporation to a local hospital (which is a charitable organization within the meaning of section 23 (q)) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the corporation's employees are not contributions or gifts within the meaning of section 23 (q) and may be deductible under section 23 (a) if the requirements of that section are otherwise satisfied. Donations to organizations other than those described in section 23 (q) which bear a direct relationship to the corporation's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses. For example, a street railway corporation may donate a sum of money to an organization (of a class not referred to in section 23 (q)) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its cars.*

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.] [In computing net income there shall be allowed as deductions:]

(b) *Interest.* All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

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

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

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, section 121 and section 19.22 (a)-18.) In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).*

[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, 49 Stat. 1019, or by section 600 of this title);

(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.

§ 19.23 (c)-1 *Taxes.* Subject to the exceptions stated in this section and section 19.23 (c)-2 and 19.23 (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 or by section 600 of the Internal Revenue Code) 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 sections 19.131-1 to 19.131-8, inclusive, as to tax credits. Postage is not a tax. Amounts paid to States or Territories under secured debts laws in order to render securities tax exempt are deductible. Automobile license fees are 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).*

§ 19.23 (c)–2 *Federal duties and excise taxes.* Import or tariff duties paid to the proper customs officers, and business, license, privilege, excise, and stamp taxes paid to internal revenue collectors, are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they cannot be separately deducted. (See section 19.23 (a)–1.)*

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

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.] [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.

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

[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.

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

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

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 1929 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, 1936. From that date to January 1, 1939, 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, 1936, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1936. The property was sold on January 1, 1939, 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 1929	$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, 1936	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 1929	$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.*

§ 19.23 (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.*

§ 19.23 (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 sections 19.113 (a) (14)-1 and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

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

In cases in which depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113 (b) and sections 19.113 (a) (14)-1, and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive) and its salvage value and/or amount realized upon its disposition may be allowed subject to the limitations provided in the Internal Revenue Code upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depreciation.

In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the basis of the asset (adjusted as provided in section 113 (b) and sections 19.113 (a) (14)-1, and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive) less its salvage value is allowable upon its retirement. (See sections 19.23 (l)-1 to 19.23 (l)-10, inclusive.)*

§ 19.23 (e)-4 *Shrinkage in value of stocks.* A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and sections 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive, is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness. Federal or State authorities incident to the regulation of banks and certain other corporations may require that stock be charged off as worthless or written down to a nominal value. If, in any such case, the basis of the requirement is the worthlessness of the stock, such charging off or writing down will, for income tax purposes, be considered prima facie evidence of worthlessness; but if the charging off or writing down is due to market fluctuations, or if no reasonable attempt has been made to determine worthlessness, no deduction for income tax purposes of the amount so charged off or written down can be allowed. For dealers in securities, see section 19.22 (c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally, including stocks and bonds, see section 117.*

§ 19.23 (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 livestock, may be deducted as a loss if the loss is not compensated for by insurance or otherwise. The actual cost of other property (with proper adjustment for depreciation) which is destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss. If reimbursement is made by a State or the United States in whole or in part on account of stock killed or other property destroyed in respect of which a loss was claimed for a prior year, the amount received shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasture, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss. If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. As to losses claimed as deductions for estate tax purposes, see section 19.23 (e)-1. See also sections 19.22 (a)-7, 19.23 (a)-11, and 19.23 (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.

§ 19.23 (f)-1 *Losses by corporations.* Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible in so far as not prohibited or limited by sections 23 (g), 23 (h), 24 (b), 112, 117, 118, and 251. The provisions of sections 19.23 (e)-1 to 19.23 (e)-5, inclusive, and section 19.23 (i)-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) *Capital losses.*

(1) *Limitation.* Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

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

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

§ 19.23 (g)-1 *Capital losses.* Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. Losses sustained by virtue of securities becoming worthless during the taxable year are, under section 23 (g), made subject to the limitations provided in section 117 with respect to sales or exchanges, provided the securities are "capital assets" as that term is defined in section 19.117 (a)-1. For purposes of computing the net income of any taxpayer, such losses are to be considered as being sustained from the sale or exchange of the securities on the last day of the taxable year, irrespective of when during the taxable year such securities actually became worthless.

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

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

Example. A, an individual, who is not a dealer in corporate stocks or stock rights and whose taxable year is the calendar year, purchased 120 shares of stock in the X Corporation on February 1, 1938, for which he paid $3,000. In June, 1939, the stock became worthless. A is entitled to a deduction of $2,000 in computing his net income for 1939. The deduction is computed as follows:

Purchase price	$3,000
Amount realized	None
Actual loss	$3,000
Period stock considered to have been held (February 1, 1938, to December 31, 1939)	23 months
Percentage of loss taken into account under section 117 (b)	66⅔ percent
Long-term capital loss (66⅔ percent of $3,000) (section 117 (a) (5))	$2,000

*

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.]
[In computing net income there shall be allowed as deductions:]

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

(i) *Basis for determining loss.* The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

§ 19.23 (i)-1 *Basis for determining loss.* The basis for determining the amount of the deduction for losses allowed to individuals under section 23 (e) and to corporations under section 23 (f), or of the amount of the deduction for bad debts allowed to both individuals and corporations under section 23 (k), is the same as is provided in section 113 for determining the loss from the sale or other disposition of property. Proper adjustment must be made in each case for any expenditure, receipt, loss, or other item properly chargeable to capital account, and for depreciation, obsolescence, amortization, or depletion. (See section 113 (b) and sections 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive.)*

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.]
[In computing net income there shall be allowed as deductions:]

(j) *Loss on wash sales of stock or securities.* For disallowance of loss deduction in the case of sales of stock or securities where within thirty days before or after the date of the sale the taxpayer has acquired substantially identical property, see section 118.

(k) *Bad debts:*

(1) *General rule.* Debts 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. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection.

(2) *Securities becoming worthless.* If any securities (as defined in paragraph (3) of this subsection) are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in section 104, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

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

§ 19.23 (k)-1 *Bad debts.* (a) Bad debts may be treated in either of two ways—

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

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

Taxpayers were given an option for 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 all subsequent years unless permission is granted by the Commissioner to change to the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also section 19.23 (k)-5.)

(b) 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.

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

(d) The provisions of subdivisions (a) and (b) of this section apply to all taxpayers, except that in the case of taxpayers other than banks as defined in section 104, the term "debts" as used in such subdivisions means obligations to pay fixed or determinable sums of money which are not evidenced by securities as defined in section 19.23 (k)-4.*

§ 19.23 (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 cannot 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.*

§ 319.23 (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.*

§ 19.23 (k)-4 *Worthless bonds and similar obligations.* Except only in the case of a bank, as defined in section 104, no deduction is allowable under section 23 (k) (1) to any taxpayer with respect to a debt (evidenced by a security) which has become worthless in whole or in part. If a security is a capital asset and is ascertained to be worthless and is charged off during the taxable year, a deduction for the loss resulting therefrom is allowable under section 23 (k) (2) to a taxpayer other than a bank. Such a loss, however, is made subject to the limitations provided in section 117 with respect to sales or exchanges. For the purposes of computing the net income of any taxpayer, other than a bank as defined in section 104, such a loss is to be considered as being sustained from the sale or exchange of the security on the last day of the taxable year, irrespective of when during the taxable year such security was ascertained to be worthless and charged off as required. No deduction is allowable under section 23 (k) (2) with respect to a debt evidenced by a security which is recoverable in part.

As used in section 23 (k) and this section the term "security" means a bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued at any time by a domestic or foreign corporation (including that issued by any government or political subdivision thereof), either in registered form or accompanied by interest coupons.

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

A taxpayer (other than a dealer in bonds or other similar obligations) possessing debts evidenced by bonds or other similar obligations cannot deduct from gross income any amount merely on account of market fluctuation. If 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 (which bonds or other obligations are not securities as defined in this section) 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. A bank as defined in section 104 may deduct such uncollectible part of the debt even though the evidence of the debt is a security as defined in this section.

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

Example (1). On February 1, 1938, A, an individual, who is not a dealer in corporate bonds, purchased bonds of the X Corporation bearing interest coupons payable semiannually, for which he paid $3,000. During the calendar year 1939 (his taxable year) the bonds became worthless and he made a proper charge-off during that year. A is entitled to a deduction of $2,000 in computing his net income for 1939. The computation of the amount of the deduction is the same as the computation in the example under section 19.23 (g)-1.

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

§ 19.23 (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 section 19.23 (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:]

(l) *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.

§ 19.23 (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.*

§ 19.23 (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 Internal Revenue Code. (See sections 23 (m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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 section 19.22 (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.*

§ 19.23 (l)-5 *Method of computing depreciation allowance.* The capital sum to be recovered shall be charged off over the usual 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, 1934, 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 1934 to 1938 as follows:

1934	$1,000.00
1935	---------
1936	2,000.00
1937	2,000.00
1938	---------
Total amount allowed	5,000.00

The correct amended reserve as of December 31, 1938, is computed as follows:

December 31—	
1934	$1,000.00
1935	1,000.00
1936	2,000.00
1937	2,000.00
1938	666.67
Reserve December 31, 1938	6,666.67

Depreciation for 1939 and subsequent taxable years is $666.67 computed as follows:

Cost	$10,000.00
Reserve as of December 31, 1938	6,666.67
Unrecovered cost	3,333.33
Depreciation allowable for 1939 and each subsequent taxable year (6⅔ percent of $10,000)	666.67

*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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 section 19.22 (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 therof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. (See also sections 19.23 (a)-11 and 19.23 (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 depiction) 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.

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

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not posses an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. (But see section 19.115-6.) 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 section 19.23 (l)-1.)

When used in these sections (19.23 (m)-1 to 19.23 (m)-28, inclusive) covering depletion and depreciation—

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

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

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

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

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

(f) "Gross income from the property," as used in section 114 (b) (3) and (4) and sections 19.23 (m)-1 to 19.23 (m)-28, inclusive, means the amount for which the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine or well, but, if the product is transported or processed (other than by the processes excepted below) before sale, it means the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before such transportation or processing. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes not listed below. The processes excepted are as follows:

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

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

(3) In the case of iron ore 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 case any of the excepted processes are not applied in the immediate vicinity of the mining district in which the mine is located, costs incurred for transportation to the processing location and, if transported by taxpayer, the proportionate profits attributable to transportation should be subtracted from the sale price of the product to determine "gross income from the property."

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

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 19.23 (m)-10 (e).

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and sections 19.23 (m)-1 to 19.23 (m)-28, inclusive, means the "gross income from the property" as defined in paragraph (f) of this section less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (f), deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (f) and (2) the additional activities taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (f) bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (f) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

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

(i) "The property," as used in section 114 (b) (2), (3), and (4) and sections 19.23 (m)-1 to 19.23 (m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.*

§ 19.23 (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 sections 19.113 (a)-1 to 19.114-1, inclusive.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

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

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

In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (a) amounts representing the cost or value of the land for purposes other than mineral production, (b) the amount recoverable through depreciation and through deductions other than depletion, and (c) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in section 19.23(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.*

§ 19.23 (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 owners of the economic interests therein. For the method of determining whether a discovery has been made, see section 19.23 (m)-14. For the method of determining the fair market value, see section 19.23 (m)-7.

With respect to any property for which discovery value is the taxpayer's basis for depletion, the depletion for any taxable year shall be computed by (1) adding to the discovery value of the mineral deposit in the property any subsequent allowable capital additions made by the taxpayer, (2) subtracting the aggregate of depletion deductions with respect to the property which would previously have been allowable to the taxpayer without the application of any net income limitations, (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 section shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion be less than it would be if computed without reference to discovery value. For definition of "net income of the taxpayer (computed without allowance for depletion) from the property," see paragraph (g) of section 19.23 (m)-1.

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

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

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

§ 19.23 (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 paragraphs (f) and (g) of section 19.23 (m)-1.) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.*

§ 19.23 (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 section 19.23 (m)-1 (f) and (g).)

Subject to the qualification specified in the last sentence of this paragraph, a taxpayer making his first return under chapter 1 (for a taxable year beginning after December 31, 1938) 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 section the taxpayer's first return under chapter 1 in respect of a property is the return made under that chapter for his first taxable year (beginning after December 31, 1938) 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 section cannot 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 section, 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 the Revenue Act of 1936, and the Revenue Act of 1938, and as giving no new election in cases where any of such sections would, if applied, give no new election.*

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

§ 19.23 (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 partciular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight, (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property; (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the mineral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

(b) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors essential in the case of all mineral deposits are (1) the total expected profit, (2) the rate at which this profit will be obtained, and (3) the rate of interest commensurate with the risk for the particular deposit. In case of oil and gas properties the additional factors are (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 allocation of the total expected profit to the several processes or operations necessary for the preparation of the oil and gas for market, (E) the probable operating life of the deposit in years, (F) the development cost, and (G) the operating cost. In order to estimate the total expected profit from the operation of mines it is necessary to determine the quantity, quality, and recoverable mineral content of the developed, probable, and prospective ore reserves in all cases. For mines with a prior operating record the "spread of profit" per unit of recoverable mineral, or the percentage of net profit to gross proceeds from mineral production is the other factor required in estimates of the total expected profit. For mines with no prior operating record the future sales price and future production cost per unit of mineral must be estimated in order to determine the "spread of profit" per unit of recoverable mineral.

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

(d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued separately. The mineral content of a deposit shall be determined in accordance with section 19.23 (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 sections 19.23 (m)-15 and 19.23 (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 section 19.23 (m)-16. This cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

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

(f) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any mineral property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral property in fee simple.*

§ 19.23 (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 section 19.23 (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 section 19.23 (m)-9, and

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

§ 19.23 (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.*

§ 19.23 (m)-10 *Depletion—Adjustments of accounts based on bonus or advanced royalty.*

(a) If a bonus in addition to royalties is received upon the grant of rights in mineral property, there shall be allowed to the payee as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance.

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

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

(d) In lieu of the treatment provided for in paragraphs (a) and (b) above the owner of an economic interest in oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the owner of an economic interest in sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year beginning after December 31, 1938, 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.

(e) If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

(2) As deductions from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

The option contained in this paragraph shall apply only to advanced royalties paid or accrued in taxable years ending on or after December 31, 1939. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrue. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with paragraph (e) (2) above. Any election made under this section is binding for all subsequent years and the taxpayer must treat all advanced royalties paid or accrued in such subsequent years in the same manner.*

§ 19.23 (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 cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with section 19.23 (m)-2, 19.23 (m)-3, 19.23 (m)-4, or 19.23 (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 section 19.23 (m)-3, 19.23 (m)-4, or 19.23 (m)-5.

Every taxpayer to whom section 114 (b) (2) and section 19.23 (m)-3 are applicable shall keep similar accounts with respect to discovery value.*

§ 19.23 (m)-12 *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.*

(a) Except as provided in section 19.23 (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) The nature of the taxpayer's interest in the property, accompanied by a certified copy of the instrument or instruments by which it was acquired;

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

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

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

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

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

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

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

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

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

(12) The amounts of depletion and depreciation, stated separately, which for each and every prior year (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 to the top of each of the different pay sands;

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

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

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

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

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

§ 19.23 (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 section 19.23 (m)-4, or depletion of coal mines, metal mines, or sulphur mines or deposits under section 114 (b) (4) and section 19.23 (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 (f) of section 19.23 (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 (g) of section 19.23 (m)-1; and

(3) The information required by paragraphs (a) (1), or (a) (2), (a) (3), and (b) of section 19.23 (m)-12. The other information required by section 19.23 (m)-12 shall also be furnished if necessary in determining the gain or loss from the sale or other disposition of the property during the taxable year or if a valuation of the property is necessary for any purpose. The taxpayer may find it desirable to furnish such information in all cases.

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

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

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

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

(e) The value of property claimed as the result of a discovery must be the fair market value, as defined in section 19.23 (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.*

§ 19.23 (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.*

§ 19.23 (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 amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(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 section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

(d) This section does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)-16 of Regulations 86 or under article 23 (m)-16 of Regulations 94 [section 3.23 (m)-16, Title 26, Code of Federal Regulations] or under article 23 (m)-16 of Regulations 101 [section 9.23 (m)-16, Title 26, Code of Federal Regulations] is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1939, or after December 31, 1938, 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, 1938, must make an election as to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures, and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1938, 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 much attach to his return for the first taxable year beginning after December 31, 1938, 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.*

§ 19.23 (m)-17 *Depreciation in the case of mines.*

(a) The Internal Revenue Code provides that deductions for depreciation of improvements on mining property may be taken "according to the peculiar conditions in each case." This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence. (See sections 19.23 (l)-1 to 19.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly section 19.23 (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 section 19.23 (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.*

§ 19.23 (m)-18 *Depreciation of improvements in the case of oil and gas wells.* Taxpayers operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under section 19.23 (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 sections 19.23 (l)-1 to 19.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly section 19.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)*

§ 19.23 (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.*

§ 19.23 (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 section 19.113 (b) (1)-1. The apportionment of deductions between the several owners of economic interests in timber properties will be made as specified in section 19.23 (m)-7. The cost of timber properties shall be determined in accordance with the principles indicated in section 19.23 (m)-6. For method of determining fair market value and quantity of timber, see sections 19.23 (m)-25 to 19.23 (m)-27, inclusive. For depletion purposes the cost of the timber shall not include any part of the cost of the land.*

§ 19.23 (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 sections 19.23 (m)-27 and 19.23 (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.*

§ 19.23 (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 section 19.23 (m)-26.*

§ 19.23 (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 sections 19.23 (l)-1 to 19.23 (l)-10, inclusive, as to deductions for depreciation and obsolescence generally. See particularly section 19.23 (l)-5 with regard to information which must be furnished in substantiation of deductions claimed for depreciation and obsolescence.)*

§ 19.23 (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.*

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

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

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

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

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

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

If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any timber property must be ascertained as of any specific date for the determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the timber property in fee simple.*

§ 19.23 (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.*

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

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

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

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

§ 19.23 (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 sections 19.113 (a) (14)-1 and 19.113 (b) (1)-1 to 19.113 (b) (3)-2, inclusive. In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each. (See section 19.23 (m)-27.) These accounts shall be credited with the amount of the depreciation and depletion deductions computed in accordance with section 19.23 (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 payment of which is made within the taxable year to or for the use of:

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

(2) a domestic corporation, or domestic trust, or domestic 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, 43 Stat. 611 (U.S.C., Title 38, § 440);

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

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

to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection. 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.

SEC. 224. CHARITABLE CONTRIBUTIONS TO POSSESSIONS AND CHARITIES IN POSSESSIONS. (REVENUE ACT OF 1939.)

(a) *Charitable deductions of taxpayers other than corporations.* Section 23(o) (1) and (2) of the Internal Revenue Code are amended to read as follows:

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

"(2) A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;".

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SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

§ 19.23 (o)-1 *Contributions or gifts by individuals.* A deduction is allowable under section 23 (o) only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A deduction is not allowable, however, for the actual payment of a contribution or gift if the amount of such payment already has been deducted on the accrual basis in computing net income for any taxable year beginning before January 1, 1939. A contribution or gift to a domestic organization described in section 23 (o), prior to its amendment, and (for any taxable year beginning after December 31, 1939) to an organization described in section 23 (o), as amended, is deductible even though some portion of the funds of such organization is or may be used in foreign countries for charitable and educational purposes. This section does not apply to contributions or gifts by estates and trusts (see section 162).

A contribution or gift to the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or (for any taxable year beginning after December 31, 1939) any possession of the United States, exclusively for public purposes, is deductible.

No deduction is allowed in computing the net income of a common trust fund or a partnership for contributions or gifts made to organizations described in section 23 (o). (See sections 169 and 183.) However, a partner's proportionate share of contributions or gifts actually paid by a partnership during its taxable year to such organizations may be allowed as a deduction in his individual personal return for his taxable year with or within which the taxable year of the partnership ends, to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 percent of his net income computed without the benefit of the deduction for contributions. In the case of a nonresident alien individual or a citizen of the United States entitled to the benefits of section 251, see sections 213 (c) and 251. For contributions or gifts by corporations, see section 19.23 (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 section 19.51-1.)

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.

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 compaign expenses, are not deductible from gross income.

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

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

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.] [In computing net income there shall be allowed as deductions:]

(p) *Pension trusts.*

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

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

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

§ 19.23 (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) reasonable 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) reasonable 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.

Deductions under section 23 (p) of the Internal Revenue Code or under a similar section of a prior Revenue Act and apportioned to any taxable year beginning after December 31, 1937, shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer which ends with or within a taxable year of the trust with respect to which the trust is exempt from tax under section 165. As to what constitutes an exempt employees' trust, see section 19.165-1.

If any portion of the funds of an exempt pension trust reverts to the possession, ownership, or control of the employer by reason of the termination of the trust or otherwise, such amount (except to the extent that it represents a payment to the pension trust made by the employer in accordance with the pension plan and pursuant to the first paragraph of this section, 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.

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 section 23 (p) and this section for the taxable year which was allowable as a deduction from gross income for any prior taxable year.

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

Example (1)—Accruals in advance of pensions granted. In 1940 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 $3,950,000 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 1940, 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 1940, 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 1940 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 1940 was $360,000.

The deduction for 1940 is computed as follows:

(a) Entire amount paid to pension trust representing the pension liability applicable to 1940 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 1940, 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 not allowable as a deduction for income tax purposes since it was paid by the pension trust and not by the M Company.

Example (2)—Accruals on basis of pensions granted. In 1940 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 1940 was $2,000,000; the present value of the expected future payments in respect of pensions granted to employees retired during 1940 was $300,000. The amount paid to retired employees of the N Company by the pension trust as pensions during 1940 was $360,000.

The deduction for 1940 is computed as follows:

(a) Entire amount paid to the pension trust representing the present value of the expected future payments in respect of pensions granted to employees retired during 1940	$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 1940	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.

Example (3). In 1937 the Y Company adopted a reasonable pension plan and established a pension trust exempt from tax under section 165 of the Revenue Act of 1936 but which would not be exempt from tax for taxable years beginning after December 31, 1939, under section 165 of the Internal Revenue Code. The Y Company and the trust make their income returns on a calendar year basis. On July 1, 1937, the Y Company pays $50,000 into the trust, for which under section 23 (p) of the Revenue Act of 1936 it is entitled to a deduction of $5,000 for each of the 10 consecutive years beginning with the calendar year 1937. On December 31, 1939, the Y Company makes all necessary changes in the trust so as to satisfy the requirements of section 165 of the Internal Revenue Code. The Y Company is entitled to an annual deduction of $5,000 for the remaining portion of the 10-year period which began in 1937. If, however, the Y Company does not make the necessary changes so as to satisfy the requirements of section 165 of the Internal Revenue Code with respect to taxable years beginning after December 31, 1939, it is not entitled to any further deductions under section 23 (p). If it did not make such necessary changes until December 31, 1940, it is not entitled to a deduction of $5,000 for the year 1940 but is entitled to such annual deduction, however, for all subsequent taxable years up to and including the calendar year 1946.*

§ 19.23 (p)-2 *Information to be furnished by employer claiming deductions.* If a deduction from gross income is claimed under section 23 (p) in an income return or in a claim for refund on account of payments to an employees' pension trust, the employer shall file with such return or claim for refund 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. 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, shall likewise be filed. If such statements have once been filed and if the return contains a statement when and where such statements were filed, they need not again be filed; but, however, if changes in the pension trust plan have been made, a statement showing the nature of such changes (together with copies of any amendments to the trust indenture and other documents constituting a part of the plan) must be filed with the return for the first taxable year for which allowance of deductions under section 23 (p) may be affected by such changes in the pension trust plan.

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

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

2. (a) Schedules showing the computation of the reserve liability for all employees in the active service as determined from the most recent actuarial valuation. For taxable years beginning after December 31, 1938, the most recent actuarial valuation, for the purposes of this section, means such a valuation made not earlier than five years prior to the filing of the return.

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

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

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

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

5. A schedule showing the receipts and disbursements of the pension fund during each taxable year carried forward from the date the pension trust was established. The receipts should include the accruals mentioned in 3 above, interest, and any other moneys credited to the fund. The disbursements should include actual pension payments made to retired employees and any other expenditures charged to the pension fund.

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 2, 3, and 4 above should be available showing the application of both the old and the new valuation factors to the pay roll as of the valuation date coinciding with or next following the date of the change.

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 2 and 3 above need not be furnished.*

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.] [In computing net income there shall be allowed as deductions:]

(q) *Charitable and other contributions by corporations.* In the case of a corporation, contributions or gifts payment of which is made within the taxable year to or for the use of 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.

SEC. 224. CHARITABLE CONTRIBUTIONS TO POSSESSIONS AND CHARITIES IN POSSESSIONS. (REVENUE ACT OF 1939.)

* * * * * * *

(b) *Charitable deduction of corporations.* Section 23 (q) of the Internal Revenue Code is amended to read as follows:

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

SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

§ 19.23 (q)-1 *Contributions or gifts by corporations.* A corporation may deduct from its gross income, for taxable years beginning after December 31, 1938, and before January 1, 1940, contributions or gifts to organizations described in section 23 (q), prior to its amendment, and for taxable years beginning after December 31, 1939, contributions or gifts to organizations described in section 23 (q), as amended. Such deduction shall, to the extent provided by that section, be allowed only for the taxable year in which such contributions or gifts are actually paid, regardless of when pledged and regardless of the method of accounting employed by the corporation in keeping its books and records. As to charitable contributions by corporations not deductible under section 23 (a), see section 19.23 (a)-13. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses are not deductible from gross income.

The provisions of the last paragraph of section 19.23 (o)-1, relating to (1) the statement in returns of the name and address of each organization to which a contribution or gift was made and the amount and the approximate date of the actual payment of the contribution or gift, (2) the substantiation of the claims for deductions when required by the Commissioner, and (3) the basis for calculation of the amount of a contribution or gift which is other than money, are equally applicable to claims for deductions of contributions or gifts by corporations under section 23 (q).*

[SEC. 23. DEDUCTIONS FROM GROSS INCOME.] [In computing net income there shall be allowed as deductions:]

(r) *Dividends paid by banking corporations.*—

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

SEC. 211. NET OPERATING LOSSES. (REVENUE ACT OF 1939.)

(a) Section 23 of the Internal Revenue Code (relating to deductions from gross income) is amended by inserting at the end thereof the following:

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

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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; or

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

(b) *Losses from sales or exchanges of property.*

(1) *Losses disallowed.* In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2) (D);

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(D) Between a grantor and a fiduciary of any trust;

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

(F) Between a fiduciary of a trust and a beneficiary of such trust.

(2) *Stock ownership, family, and partnership rule.* For the purposes of determining, in applying paragraph (1), the ownership of stock—

(A) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(B) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(C) An individual owning (otherwise than by the application of subparagraph (B)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(D) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

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

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

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

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

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

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

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

§ 19.24-1 *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 section 19.22 (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.*

§ 19.24-2 *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 section 19.22 (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 Internal Revenue Code, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.*

§ 19.24-3 *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 sections 19.22 (a) (3) and 19.23 (a)-6 to 19.23 (a)-9, inclusive.) In either case the proceeds of such policies paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, provided the beneficiary is not a transferee of the policy for a valuable consideration. (See section 22 (b) (1) and (2) and section 19.22 (b) (1)-1.)*

§ 19.24-4 *Amounts allocable to exempt income, other than interest.*

(a) *Class of exempt income.* As used in this section, the term "class of exempt income" means any class of income, 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 chapter 1. Included are any item or class of income, other than interest, constitutionally exempt from the taxes imposed by chapter 1; any item or class, other than interest, excluded from gross income under any provision of section 22 or section 116; and any item or class of income, other than interest, exempt under the provisions of any other law from the taxes imposed by chapter 1.

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

(b) *Determination of amounts allocable to a class of exempt income.* No deduction may be allowed for the amount of any item or part thereof allocable to a class 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.

(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 section (see section 54).*

§ 19.24-5 *Losses from sales or exchanges between certain classes of persons.*

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

(b) *Corporations (including shareholders)*. In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24 (b) (1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual shareholder (see section 24 (b) (1) (B)) or between two corporations (see section 24 (b) (1) (C)). Under section 24 (b) (1) (B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. Under section 24 (b) (1) (C), however, as provided therein, not only must more than 50 percent in value of the outstanding stock of each of such corporations be owned, directly or indirectly, on the date of the sale or exchange by or for the same individual, but one of the corporations must be either a personal holding company as defined in section 501, or a foreign personal holding company as defined in section 331, for the taxable year preceding the date of the sale or exchange. It is not necessary that either of the corporations be a personal holding company or a foreign personal holding company on the date of the sale or exchange.

(c) *Stock ownership rule*. For the purpose of paragraph (b) of this section, the ownership of stock shall be determined in accordance with the rules provided in section 24 (b) (2). In order that an individual shall be considered under section 24 (b) (2) (C) as constructively owning the stock of a corporation owned, directly or indirectly, by or for his partner, such individual must himself own, directly or indirectly, stock of such corporation. On the other hand, under section 24 (b) (2) (B) an individual need not own any stock of a corporation, either directly or indirectly, in order to be considered as constructively owning the stock of such corporation which is owned, directly or indirectly, by or for any member of his family.

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

Example (1). On July 1, 1939, the M Corporation owned all of the stock of the O Corporation which for the calendar year 1938 was a personal holding company under section 402 of the Revenue Act of 1938. On that day all of the outstanding stock of the M Corporation was owned by A. By the application of the rule provided in section 24 (b) (2) (A), the stock in the O Corporation owned by the M Corporation is considered to be owned constructively by A, the sole stockholder of the M Corporation. Such constructive ownership of the stock of the O Corporation by A is considered as actual ownership for the purpose of applying the family rule provided in section 24 (b) (2) (B) to make a member of A's family, as, for example, his wife AW, the constructive owner of the stock of the O Corporation. But the constructive ownership of the O Corporation stock by AW may not be considered as actual ownership by AW for the purpose of again applying the family rule so as to make a member of AW's family, for example, her father, AWF, in turn constructive owner of such stock. These rules apply in the same manner and with the same effect in determining the ownership of stock in the M Corporation.

Accordingly, assuming that A, AW, AWF, the M Corporation and the O Corporation make their income returns on the basis of a calendar year and that there was no distribution in complete or partial liquidation of the M or O Corporation, no deduction is allowable under section 24 (b) (1) with respect to losses from sales or exchanges of property made on July 1, 1939, between any of such individuals or corporations, except as between A and AWF and between AWF and the M or O Corporation.

Example (2). On June 15, 1939, all of the stock of the N Corporation was owned in equal proportions by A and A's partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1939, between A and the N Corporation or AP and the N Corporation inasmuch as, by the application of section 24 (b) (2) (C), each partner is considered as having owned the stock owned by the other and, therefore, is considered as having owned more than 50 percent in value of the outstanding stock of the N Corporation. Deductions for losses from sales or exchanges between A's brother, AB, and the N Corporation, or between AP and A, or AP and AB are not prohibited by section 24 (b).*

§ 19.24-6 *Disallowance of deductions for unpaid expenses and interest*. The application of section 24 (c) may be illustrated by the following example:

Example. A is the holder and owner of an interest-bearing note executed by the M Corporation all of the stock of which is owned by him. A and the M Corporation make their income returns on the basis of a calendar year but the M Corporation makes its returns on the accrual basis and A makes his returns on the cash receipts and disbursements basis. The M Corporation does not pay any interest on such note during the calendar year 1939 or within two and one-half months after the close thereof, but claims a deduction for the year 1939 with respect to the interest accruing on the note in that year. A, being on the cash receipts and disbursements basis, does not include such interest in his return for the year 1939. By the application of section 24 (c), no deduction for such interest is allowable in computing the net income of the M. Corporation for the year 1939. The provisions of such section 24 (c) do not otherwise affect the general rules governing the allowance of deductions under the accrual basis. Hence, in the event the M Corporation should pay such interest after March 15, 1940, no deduction therefor would be allowable in computing its net income for the year in which the payment was made.*

§ 19.24-7 *Life or terminable interests.* Amounts paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time. (See section 113 (a) (5).)

No deductions shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, if the estate or trust is entitled to a deduction under chapter 1 but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss, but must include in his return the full amount distributed or distributable. (See section 162.) However, in the case of property held by one person for life with remainder to another person and in the case of property held in trust, see section 23 (l) as to depreciation and section 23 (m) as to depletion.*

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 or a married person not living with husband or wife, 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.

§ 19.25–1 *Credits of individual against net income.* For the purpose of computing the normal tax the taxpayer's net income as determined pursuant to sections 21 to 24, inclusive, is first reduced by the sum of the allowable credits. These include interest exempt from normal tax only (and hence included in gross income) received upon (1) obligations of the United States and 2 obligations of corporations organized under Act of Congress which are instrumentalities of the United States; an earned income credit; a personal exemption; and a credit for dependents. (See section 22 (b) (4).) For the purpose of computing the surtax the taxpayer's net income is entitled to none of these credits, except the credit for personal exemption and credit for dependents.*

§ 19.25–2 *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 1939 amounting to $6,000. His allowable deductions under section 23 for that year amounted to $2,000. He is entitled to an earned income credit of $300, computed as follows:

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

Example (2). An individual received a salary of $20,000 as a traveling salesman for the calendar year 1939. 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 1939 an individual was engaged in a business in which both personal services and capital were income-producing factors. A reasonable allowance as compensation for the personal services actually rendered by the taxpayer in the conduct of the business for that year was $10,000. The net profits of the business were $35,000, which constituted his net income for the year. He is entitled to an earned income credit of $700, computed as follows:

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

*

§ 19.25–3 *Amount of personal exemption allowable.* A single person or a married person not living with husband or wife is entitled to a personal exemption of $1,000 and the head of a family or a married person living with 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.*

§ 19.25-4 *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 Internal Revenue Code must depend on the character of the separation. If a father is absent on business, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not thereby entitled to credit as the head of a family. As to the amount of the exemption, see section 19.25-3.*

§ 19.25-5 *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 Internal Revenue Code must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together within the meaning of the Code, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption.*

§ 19.25-6 *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.*

§ 19.25-7 *Personal exemption and credit for dependents where status changes.* If the status of the taxpayer changes during the taxable year, the personal exemption allowed by section 25 (b) (1) to a single person, a married person not living with husband or wife, a head of a family, or a married person living with husband or wife, and the credit for dependents allowed by section 25 (b) (2) will be apportioned according to the number of months during which the taxpayer occupied each status. A taxpayer not having the status of a head of a family or the status of a married person living with husband or wife shall be considered as having the status of a single person. For the purpose of the apportionment of the personal exemption and credit for dependents a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month. In general, the personal exemption and credit for dependents allowable to any taxpayer will be the sum of the amounts apportioned to the several periods of the taxable year during which each status was occupied.

Example (1). A, who had been single during the preceding months of 1939, 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 1939, the personal exemption will be $2,208.33; that is, $\frac{7}{12}$ of $1,000 for A while single, plus $\frac{7}{12}$ of $1,000 for B while single, plus $\frac{5}{12}$ 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 1939, each may claim a personal exemption of $1,104.17: that is, $\frac{7}{12}$ of $1,000 plus $\frac{1}{2}$ of $\frac{5}{12}$ of $2,500. In the latter case, however, the joint exemption of $\frac{5}{12}$ 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 1939, were married on July 1, 1939, 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 1939, the personal exemption will be $3,750; that is, $\frac{1}{2}$ of $2,500 for A while the head of a family, plus $\frac{1}{2}$ of $2,500 for B while the head of a family, plus $\frac{1}{2}$ 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 1939, each may claim a personal exemption of $1,875; that is, $\frac{1}{2}$ of $2,500, plus $\frac{1}{2}$ of $\frac{1}{2}$ of $2,500. In the latter case, however, the joint exemption of $\frac{1}{2}$ 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, 1939, 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, $\frac{1}{2}$ of $\frac{11}{12}$ 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 $\frac{1}{12}$ 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 1939 on the calendar year basis, he may claim a personal exemption of $1,229.16; that is, $\frac{1}{2}$ of $\frac{11}{12}$ of $2,500, or $1,145.83, plus $\frac{1}{12}$ 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, $\frac{11}{12}$ 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, 1939. If A makes a return on the calendar year basis for 1939, 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, $\frac{6}{12}$ of $400.

Example (5). A and B were married and living together until June 30, 1939, 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 1939 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, $\frac{6}{12}$ 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, $\frac{6}{12}$ 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 chapter, but not in excess of 85 per centum of the adjusted net income. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, 42

Stat. 849 (U.S.C., Title 15, c. 4), or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

(c) *Net operating loss of preceding year.*

(1) *Amount of credit.* The amount of the net operating loss (as defined in paragraph (2)) of the corporation for the preceding taxable year (if beginning after December 31, 1937), but not in excess of the adjusted net income for the taxable year.

(2) *Definition.* As used in this chapter the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the following exceptions and limitations—

(A) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(B) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

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

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

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

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

SEC. 211. NET OPERATING LOSSES. (REVENUE ACT OF 1939.)

* * * * *

(j) *Technical amendment.* Section 26 (c) (2) of the Internal Revenue Code (relating to operating loss credit) is amended by striking out "chapter" and inserting in lieu thereof "section".

§ 19.26-1 *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.*

§ 19.26-2 *Credit of corporation for net operating loss of preceding year.* Since the net operating loss credit allowed by section 26 (c) cannot exceed the adjusted net income for the taxable year, it is the smaller of the following amounts:

(a) The excess of the deductions allowed by chapter 1 for the preceding taxable year over gross income for such year, both computed in accordance with the exceptions and limitations provided by section 26 (c) (2).

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

In computing deductions for the preceding taxable year any deduction for depletion shall be computed without reference to discovery value or percentage depletion under section 114 (b) (2), (3), or (4) (see section 19.23 (m)-2). The basis for such depletion is the basis provided in section 113 (a), adjusted as provided in secton 113 (b), for the purpose of determining the gain upon the sale or other disposition of the property involved.

In computing the gross income for the preceding taxable year there must be included the excess, if any, of the amount of any interest received which is wholly exempt from taxes imposed by chapter 1 over the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

If the preceding taxable year is one beginning after December 31, 1937, and before January 1, 1939, the term "net operating loss" means net operating loss as defined in section 26 (c) of the Revenue Act of 1938.

Example. For 1940 the X Corporation, which makes its income tax returns on the calendar year basis, has a net income of $10,000, included in which is $2,000 of interest on United States obligations allowed as a credit under section 26 (a). For 1939 its gross income was $5,000, and its allowable deductions were $10,000. Included in such deductions was $3,000 for depletion based on discovery value. If depletion had been computed without reference to discovery value or to percentage depletion the amount of such deduction would have been $1,000. For 1939 the corporation had $3,000 of wholly tax-exempt interest, and paid $2,000 in interest on indebtedness incurred to carry the obligations from which such tax-exempt interest was derived. The net operating loss credit available to such corporation for 1940 is $2,000, computed as follows:

Deductions for 1939		$10,000
Less excess of depletion deduction computed on basis of discovery value over amount allowable for depletion without reference to discovery value or percentage depletion ($3,000—$1,000)		2,000
Deductions as limited by section 26 (c) (2) (A)		$8,000
Gross income for 1939	$5,000	
Plus tax-exempt interest minus interest paid ($3,000—$2,000)	1,000	
Gross income contemplated by section 26 (c) (2) (B)		6,000
Excess of deductions over gross income for 1939		2,000
Net income for 1940		10,000
Less credit under section 26 (a) for interest received		2,000
Adjusted net income for 1940		8,000

The net operating loss credit is $2,000, that amount not being in excess of the adjusted net income for 1940.*

§ 19.26-3 *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 under section 26 (d) for the amount of readily marketable assets acquired and on hand at the beginning of the first taxable year subject to the Internal Revenue Code, whether or not a credit was allowed for all or part of such amount under section 26 (d) of the Revenue Act of 1936 or the Revenue Act of 1938, or for an amount of readily marketable assets in excess of what is required by such section 5144 to be acquired by such affiliate, or in excess of the adjusted net income for the taxable year. Nor may the aggregate of the credits allowable under section 26 (d) of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code exceed the amount required to be devoted under section 5144 to the acquisition of readily marketable assets other than bank stock.

Every taxpayer claiming and making a deduction for the credit provided for in section 26 (d) shall attach to its return a supplementary statement, in duplicate, setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144 (b) and (c) of the Revised Statutes (paragraph 95 of the Appendix to these regulations).*

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in general.* As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

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

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

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

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

SEC. 222. RENEWAL OF INDEBTEDNESS. (REVENUE ACT OF 1939.)

(a) Section 27 (a) (4) of the Internal Revenue Code (relating to corporation credit for amounts used or set aside to pay indebtedness) is amended by inserting at the end thereof the following new sentence: "A renewal (however evidenced) of an indebtedness shall be considered an indebtedness."

(b) The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

* * * * *

§ 19.27 (a)-1 *Dividends paid credit.* The amount of the dividends paid credit provided by section 27 (a) is an amount equivalent to the sum of the following:

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

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

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

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

§ 19.27 (a)-2 *Deficit credit.* Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1939) over the net operating loss credit allowed by section 26 (c) for such preceding taxable year.

A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. It is the subsequent operating loss, however, and not the distribution which creates the deficit. For example, the X Corporation, which makes its income tax returns on the calendar year basis, has on January 1, 1939, accumulated earnings and profits of $100,000. During 1939 there are no further earnings and profits. On February 1, 1939, operating losses have reduced the accumulated earnings and profits account to $50,000. On March 1, 1939, $90,000 is distributed to shareholders. On April 1, 1939, an operating loss of $40,000 is incurred. There is no further change during the taxable year. Though the corporation closes its year with total assets of $180,000 less than it had on January 1, 1939, and $90,000 of that amount was attributable to operating losses, only $40,000 constitutes a deficit in accumulated earnings and profits as of the close of the year. If, however, no operating losses were incurred up to February 1, $90,000 was distributed to shareholders on February 1, a $50,000 operating loss was incurred on March 1, and a $40,000 operating loss on April 1, the corporation's deficit in accumulated earnings and profits would be $80,000 as of the close of the year.*

§ 19.27 (a)-3 *Amounts used or irrevocably set aside to pay or to retire indebtedness.*

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

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

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

Double credits are not permitted, either for the same year or for separate years. Thus, amounts which have been or may be properly taken as a credit pursuant to section 27 (e) of the Internal Revenue Code or of the Revenue Act of 1938 or section 27 (d) of the Revenue Act of 1936 (all relating to dividends in obligations of the corporation) may not again be included in the dividends paid credit under section 27 (a) (4) when the obligations are paid. No credit may be allowed under section 27 (a) (4) for amounts used or irrevocably set aside to pay or retire indebtedness which represents an item which is allowable as a deduction from gross income, either for the same year or a different year. Thus, the aggregate of the credits allowable under section 27 (a) (4) for amounts used or irrevocably set aside to pay or to retire obligations issued at a discount may not exceed the issue price of such obligations.

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

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

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

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

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

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

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

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

(2) The net operating loss credit provided in section 26 (c) (1);

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

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

§ 19.27 (b)-1 *Basic surtax credit.* The amount constituting the basic surtax credit of a corporation for the taxable year consists of the sum of the following, less the amount allowable as a deduction under section 121 (relating to the deduction of dividends paid on certain preferred stock of certain corporations):

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

(2) The smaller of the following:

(a) The sum of the net operating loss credit for the preceding taxable year provided in section 26 (c) (1) and the bank affiliate credit provided in section 26 (d).

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

§ 19.27 (b)-2 *Dividends paid.*

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

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

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

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

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

In the case of a stock dividend, if the shares (other than fractional shares payable to bearer) constituting the dividend are not entered or registered on the books of the corporation in the name of the shareholder (or his nominee or transferee) within the taxable year, the dividend will not be deemed to have 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.

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

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

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

(c) *Dividend carry-over.* There shall be computed with respect to each taxable year of a corporation a dividend carry-over to such year from the two preceding taxable years, which shall consist of the sum of—

(1) The amount of the basic surtax credit for the second preceding taxable year, reduced by the adjusted net income for such year, and further reduced by the amount, if any, by which the adjusted net income for the first preceding taxable year exceeds the sum of—

(A) The basic surtax credit for such year; and

(B) The excess, if any, of the basic surtax credit for the third preceding taxable year over the adjusted net income for such year; and

(2) The amount, if any, by which the basic surtax credit for the first preceding taxable year exceeds the adjusted net income for such year.

In the case of a preceding taxable year, referred to in this subsection, which begins in 1937, the adjusted net income shall be the adjusted net income as defined in section 14 of the Revenue Act of 1936, and the basic surtax credit shall be only the dividends paid credit computed under the Revenue Act of 1936 without the benefit of the dividend carry-over provided in section 27 (b) of such Act. In the case of a preceding taxable year, referred to in this subsection, which begins in 1938, the adjusted net income shall be the adjusted net income as defined in section 13 (a) of the Revenue Act of 1938, 52 Stat. 455, and the basic surtax credit shall be the basic surtax credit as defined in section 27 of the Revenue Act of 1938, 52 Stat. 468.

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

(a) If the basic surtax credit for the preceding taxable year exactly equals the adjusted net income for such year, the dividend carry-over is the amount of the excess of the basic surtax credit for the second preceding taxable year over the adjusted net income for such year.

(b) If the basic surtax credit for the preceding taxable year exceeds the adjusted net income for such year, the dividend carry-over is the amount of such excess plus the excess of the basic surtax credit for the second preceding taxable year over the adjusted net income for such year.

(c) If the basic surtax credit for the preceding taxable year is less than the adjusted net income for such year, the dividend carry-over is the amount by which the basic surtax credit for the second preceding taxable year exceeds the adjusted net income for such year reduced by the excess of the adjusted net income for the first preceding taxable year over the sum of the basic surtax credit for such year and the excess of the basic surtax credit for the third preceding taxable year over the adjusted net income for such year.

In computing the dividend carry-over the adjusted net income for a preceding taxable year which begins in 1937 shall be the adjusted net income as defined in section 14 (a) (1) of the Revenue Act of 1936 and the basic surtax credit for such preceding taxable year shall be only the dividends paid credit computed under section 27 of the Revenue Act of 1936 without the benefit of the dividend carry-over provided in section 27 (b) of such Act. In computing the dividend carry-over the adjusted net income for a preceding taxable year which begins in 1938 shall be the adjusted net income as defined in section 13 (a) of the Revenue Act of 1938 and the basic surtax credit for such preceding taxable year shall be the basic surtax credit as defined in section 27 of the Revenue Act of 1938.

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

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

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $150,000 and a dividends paid credit (computed without regard to any dividend carry-over) of $225,000 for 1937. For 1938 its adjusted net income is $200,000 and its basic surtax credit is $350,000, and for 1939 its adjusted net income and its basic surtax credit are each $175,000. Its dividend carry-over to 1940 is $150,000, computed as follows:

(1)	Basic surtax credit for 1938	$350,000
(2)	Less adjusted net income for 1938	200,000
(3)	Dividend carry-over to 1940 ((1) minus (2))	150,000

Since the basic surtax credit for 1939 exactly equals the adjusted net income for that year, neither that year nor the year 1937 need be taken into account. The preceding taxable year (1939) is taken into account only if the basic surtax credit for such year exceeds the adjusted net income for such year or if the adjusted net income for such year exceeds the sum of the basic surtax credit for such year and the excess of the basic surtax credit (dividends paid credit if in 1937) for the third preceding taxable year (1937) over the adjusted net income for such year. The third preceding taxable year (1937) is taken into account only if the adjusted net income for the first preceding taxable year (1939) exceeds the basic surtax credit for such year, in which case it operates to reduce the amount of such excess which must be deducted from the carry-over from the second preceding taxable year (1938).

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $100,000 and a dividends paid credit (computed without regard to any dividend carry-over) of $150,000 for 1937. For 1938 its adjusted net income is $50,000 and its basic surtax credit is $75,000, and for 1939 its adjusted net income and basic surtax credit are $25,000 and $100,000, respectively. Its dividend carry-over to 1940 is $100,000, computed as follows:

Year 1938

(1)	Basic surtax credit	$75,000	
(2)	Less adjusted net income	50,000	
(3)	Excess of basic surtax credit over adjusted net income		$25,000

Year 1939

(4)	Basic surtax credit	$100,000	
(5)	Less adjusted net income	25,000	
(6)	Excess of basic surtax credit over adjusted net income		75,000
(7)	Dividend carry-over to 1940 (sum of (3) and (6))		100,000

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

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis, has an adjusted net income of $90,000, and a dividends paid credit (computed without regard to any dividend carry-over) of $150,000 for 1937. For 1938 its adjusted net income is $60,000 and its basic surtax credit is $160,000, and for 1939 its adjusted net income and basic surtax credit are $120,000 and $25,000, respectively. Its dividend carry-over to 1940 is $65,000, computed as follows:

Year 1938

(1)	Basic surtax credit		$160,000	
(2)	Less adjusted net income		60,000	
(3)	Excess of basic surtax credit over adjusted net income			$100,000

Year 1939

(4)	Adjusted net income		$120,000	
(5)	Basic surtax credit	$25,000		

Year 1937

(6)	Dividends paid credit	$150,000			
(7)	Less adjusted net income	90,000			
(8)	Excess of dividends paid credit over adjusted net income		60,000		
	Sum of (5) and (8)			85,000	
(9)	Excess of adjusted net income over sum of items (5) and (8)				35,000
(10)	Dividend carry-over to 1940 ((3) minus (9))				65,000

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[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

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

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

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

(2) The fair market value of such property.

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

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

Example. The S Corporation, in 1931, purchased stock of the Y Corporation for $100,000. In 1939 such stock had a fair market value of $70,000. During the period of its ownership of such stock, the S Corporation received distributions amounting to $5,000 out of earnings or profits of the Y Corporation accumulated before March 1, 1913. In 1939 the corporation used such stock for the payment of a dividend. The allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1939 is $70,000, computed as follows:

Purchase price, or cost of stock	$100,000
Less tax-free distribution	5,000
Adjusted basis of stock in the hands of the corporation at the time of the dividend payment	95,000
Fair market value of stock at the time of the dividend payment	70,000
Allowance for dividends paid for purposes of inclusion in the basic surtax credit for 1939	70,000

Since the fair market value of the stock ($70,000) at the time of the dividend payment is less than the adjusted basis ($95,000) of the stock in the hands of the corporation at the time of the dividend payment, the lesser amount ($70,000) should be used as the allowance for dividends paid for purposes of computing the basic surtax credit for 1939 with respect to such stock.*

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

(e) *Dividends in obligations of the corporation.* If a dividend is paid in obligations of the corporation, the amount with respect thereto which shall be used in computing the basic surtax credit shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value of any such dividend paid in any taxable year of the corporation beginning after December 31, 1935, is lower than the face value, then when the obligation is redeemed by the corporation the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

§ 19.27 (e)-1 *Dividends in obligations of the corporation.* Section 27 (e) is concerned solely with the amount of the allowance for dividends paid for purposes of inclusion in the basic surtax credit to the extent that dividends are paid by a corporation in its own obligations. If the corporation ultimately pays a dividend in its own obligations (regardless of the form of the corporate resolution by which the dividend is declared), the amount of the allowance for dividends paid to which it is entitled with respect thereto for the year in which such dividend is paid is limited to the lesser of the face value or fair market value of such obligations as of the date of payment. If in a taxable year of the corporation beginning after December 31, 1935, the allowance for dividends paid as of the date of payment is limited to the fair market value of the corporate obligations distributed and the corporation redeems such obligations, the corporation becomes entitled to an additional allowance for dividends paid in computing the basic surtax credit for the taxable year in which it redeems such obligations, but only in the event that the amount at which such obligations are redeemed is higher than their fair market value at the time of the distribution. The amount of such additional allowance is the excess of the price at which such obligations are redeemed over their fair market value at the time of the distribution, subject to the restriction that such excess be diminished by any amounts which were allowable as deductions for amortized bond discount or bond issue commissions and expenses allocable to the obligations redeemed in computing the net income of the corporation for any taxable year. A corporation is entitled to such additional allowance regardless of the identity of the holders of the obligations at the time of their redemption.

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

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

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

The bonds were redeemed in 1939. The corporation prior to the redemption of the bonds at face value deducted in its returns over the life of the bonds the

$15,000 bond discount resulting from the payment in 1936 of the $85,000 dividend in bonds having a face value of $100,000. The allowance for dividends paid for purposes of computing the basic surtax credit with respect to the bond redemption for the taxable year 1939, 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 1939	10,000

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[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

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

§ 19.27 (f)-1 *Taxable stock dividends.* The allowance for dividends paid provided by section 27 (b) (1) is limited by section 27 (f), in the case of distributions in stock dividends or stock rights, to distributions which are taxable dividends in the hands of shareholders under section 115 (f). Such allowance, however, is limited in amount to the fair market value of such stock or stock rights at the time of the payment of the dividend. As to a distribution by a corporation of its own capital stock held as an investment, see section 19.27 (d)-1.*

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

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

§ 19.27 (g)-1 *Dividends paid credit for distributions in liquidation.*

(a) *Distributions which diminish earnings or profits.* To the general rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27 (g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Internal Revenue Code, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

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

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

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

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Internal Revenue Code, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Code as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Code. No allowance for dividends paid is permissible with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.* In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this section) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example. The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000, and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1939, 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, 1939, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Internal Revenue Code, such transaction being only a partial liquidation under section 115 (c). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is allowable as dividends paid.

(c) *Credit in respect of earnings or profits transferred under certain tax-free transactions.* If, as a result of one or more transactions described in section 112, a corporation's earnings or profits accumulated after February 28, 1913, and its undistributed earnings or profits of the taxable year, shall have become the earnings or profits of another corporation subject to distribution as dividends by such other corporation, any dividend paid by the transferee corporation during that portion of the transferor's taxable year subsequent to the consummation of such tax-free transaction may, subject to the provisions of section 115, be apportioned and allocated to the transferor as a distribution out of such earnings or profits of the transferor. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated.

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

Example. The P Corporation, which makes its income tax returns on the basis of a fiscal year ending March 31, owned all of the capital stock of the S Corporation. The S Corporation, which makes its returns on the calendar year basis, was completely liquidated on December 1, 1939. 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 1939 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, 1939, $25,000; September 15, 1939, $25,000; December 15, 1939, $25,000; and March 15, 1940, $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, 1940, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation's accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).*

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

(h) *Preferential dividends.* The amount of any distribution (although each portion thereof is received by a shareholder as a taxable dividend), not made in connection with a consent distribution (as defined in section 28 (a) (4)), shall not be considered as dividends paid for the purpose of computing the basic surtax credit, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

For a distribution made in connection with a consent distribution, see section 28.

§ 19.27 (h)-1 *Preferential distributions.* Section 27 (h) imposes a limitation upon the general rule that a corporation is entitled to an allowance for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such allowance with respect to a distribution, regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 27 (h) is unqualified, except in the case of a partial distribution (see section 28 (a) (5)) made in connection with a consent distribution as defined in section 28 (a) (4), if the entire distribution composed of such partial distribution and consent distribution (see section 28 (e) is not preferential. The existence of a preference is sufficient to prohibit allowance regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation, or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to an allowance for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to an allowance for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. The term "distribution," as used in this section, includes a dividend as defined in section 115, and a distribution in liquidation referred to in section 27 (g).

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

Example (1). A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation, on July 15, 1939, declared a dividend of $5 a share payable in cash on August 1, 1939, to A. On September 15, 1939, it declared a dividend of $5 a share payable in cash on October 1, 1939, to B, C, and D. No allowance for dividends paid for the taxable year 1939 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1939, and October 1, 1939.

Example (2). The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1939, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No allowance for dividends paid is permissible under section 27 (h) with respect to such distribution.

Example (3). The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1939, the corporation distributes a dividend of $125, $50 to E and $75 to F. The corporation is entitled to no allowance for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 in its basic surtax credit as a dividend paid.*

[SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.]

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

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

(a) not out of earnings or profits of the taxable year or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (see section 115), or, in the case of distributions in liquidation, not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under section 19.27 (g)-1;

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

(c) a distribution in stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and sections 19.115-3 and 19.115-4).

The effect of sections 27 (h) and (i) is that no allowance for dividends paid may be included in the basic surtax credit with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under chapter 1 for the period in which the distribution is made, receives a taxable dividend as a result of the distribution. (See also section 27 (g).)

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

Example (1). A, B, C, and D are the shareholders of the Y Corporation, which makes its income tax returns on the calendar year basis, D being an educational corporation exempt from income tax under section 101. On July 15, 1939, the Y Corporation paid a dividend (within the meaning of section 115) in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The Y Corporation is entitled to an allowance for dividends paid in the amount of $1,000 with respect to the dividends paid on July 15.

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

SEC. 28. CONSENT DIVIDENDS CREDIT.

(a) *Definitions.* As used in this section—

(1) *Consent stock.* The term "consent stock" means the class or classes of stock entitled, after the payment of preferred dividends (as defined in paragraph (2)), to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings or profits which share constitutes the same proportion of such distribution regardless of the amount of such distribution.

§ 19.28 (a) (1)-1 *Consent stock.* The term "consent stock," as defined in section 28 (a) (1), includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited. The application of section 28 (a) (1) may be illustrated as follows:

If in the case of the X Corporation there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

[(a) *Definitions.* As used in this section—]

(2) *Preferred dividends.* The term "preferred dividends" means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings or profits may be made within the taxable year.

§ 19.28 (a) (2)-1 *Preferred dividends.* The term "preferred dividends," as defined in section 28 (a) (2), includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution (other than in liquidation) of which on any class of stock is a condition precedent to a further distribution (other than in liquidation) of earnings or profits. A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some other class or classes of stock than the one on which it is payable. The application of section 28 (a) (2) may be illustrated as follows:

If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

[(a) *Definitions.* As used in this section—]

(3) *Consent dividends day.* The term "consent dividends day" means the last day of the taxable year of the corporation, unless during the last month of such year there have occurred one or more days on which was payable a partial distribution (as defined in paragraph (5)), in which case it means the last of such days.

§ 19.28 (a) (3)-1. *Consent dividends day.* The term "consent dividends day" is defined in section 28 (a) (3). If there was no partial distribution (as defined in section 28 (a) (5)) payable during the last month of the corporation's taxable year, the consent dividends day is the last day of such taxable year. If there were one or more days during such last month on which was payable a partial distribution, the consent dividends day is the last of such days. The day upon which shareholders, under the terms of the resolution of the board of directors directing the distribution, are entitled to receive the distribution is the day it is payable.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

[(a) *Definitions.* As used in this section—]

(4) *Consent distribution.* The term "consent distribution" means the distribution which would have been made if on the consent dividends day (as defined in paragraph (3)) there had actually been distributed in cash and received by each shareholder making a consent filed by the corporation under subsection (d), the specific amount stated in such consent.

§ 19.28 (a) (4)-1 *Consent distribution.* The term "consent distribution," as defined in section 28 (a) (4), does not include any actual distributions but is limited to the hypothetical distribution evidenced by shareholders' consents. The consent distribution equals the aggregate of all the amounts specified in the several consents, whether or not, if actually distributed, such amounts would have constituted in whole or in part a return of capital. Section 28 (a) (4) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, consisting of 500 shares, 200 of which are owned by A, and 300 by B. On December 15, 1939, the corporation distributes to A $5 per share, or $1,000. On December 31, 1939, B executes a consent to include $1,500 in his gross income as a taxable dividend. At the beginning of 1939 the corporation had no accumulated earnings or profits. For the taxable year 1939 the earnings or profits are $2,000. Nevertheless the corporation will be deemed to have made a consent distribution of $1,500 on December 15.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

[(a) *Definitions.* As used in this section—]

(5) *Partial distribution.* The term "partial distribution" means such part of an actual distribution, payable during the last month of the taxable year of the corporation, as constitutes a distribution on the whole or any part of the consent stock (as defined in paragraph (1)), which part of the distribution, if considered by itself and not in connection with a consent distribution (as defined in paragraph (4)), would be a preferential distribution, as defined in paragraph (6).

§ 19.28 (a) (5)-1 *Partial distribution.* The term "partial distribution," as defined in section 28 (a) (5), does not include preferred dividends even though payable on consent stock. The application of section 28 (a) (5) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, class A and class B, each of which is consent stock. Class A, consisting of 500 shares, is entitled to a preference of $3 per share, after which class B, consisting of 500 shares, is to receive $3 per share, whereupon class A and class B are entitled to share equally in any further distributions of earnings or profits. On December 15, 1939, the X Corporation distributes $6 per share or $3,000 on class A stock, and $3 per share or $1,500 on class B stock. Such distribution, to the extent of $1,500 paid on class A stock, is a partial distribution.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

[(a) *Definitions.* As used in the section—]

(6) *Preferential distribution.* The term "preferential distribution" means a distribution which is not pro rata, or which is with preference to any share of stock as compared with other shares of the same class, or to any class of consent stock as compared with any other class of consent stock.

§ 19.28 (a) (6)-1 *Preferential distribution.* A preferential distribution is an actual distribution (other than the distribution of a preferred dividend as defined in section 28 (a) (2)), or a consent distribution, or a combination of the two, upon consent stock, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of consent stock as compared with any other class of consent stock. Such a preference exists if there is distributed to any shareholder (in proportion to the number of shares held by him) more or less than his pro rata part of a distribution as compared with the distribution made to any other shareholder of the same class, or if there is distributed to all the shareholders of one class of consent stock in the aggregate more or less than their pro rata part of a distribution as compared with the distribution made to all the shareholders of any other class of consent stock. If such preference exists, the entire distribution is preferential.

Section 28 (a) (6) may be illustrated by the following examples:

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1939, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B each receives a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income but C agrees to include only $3,000, the consent distribution is preferential.

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1939, there is distributed on the class A stock $2 per share, or $1,000, and on the class B stock $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the distribution.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(b) *Corporations not entitled to credit.* A corporation shall not be entitled to a consent dividends credit with respect to any taxable year—

(1) Unless, at the close of such year, all preferred dividends (for the taxable year and, if cumulative, for prior taxable years) have been paid; or

(2) If, at any time during such year, the corporation has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

§ 19.28 (b)-1 *Payment of preferred dividends.* Section 28 (b) (1) provides that a corporation shall not be entitled to a consent dividends credit for any taxable year, regardless of compliance with other requirements of section 28, unless at the close of such year all preferred dividends (for the taxable year and, if cumulative, for prior taxable years) have been paid. Whatever form such payment takes, it must result in the complete discharge of the obligation of the corporation to pay such dividends. For what constitutes payment of a dividend before the close of the taxable year, see section 19.27 (b)-2. For what constitutes a preferred dividend see section 28 (a) (2). A preferred dividend will be considered paid for the purposes of this requirement, even though it is paid as part of a preferential dividend as defined in section 27 (h), and the corporation receives no credit for dividends paid in consequence thereof.*

§ 19.28 (b)-2 *Liquidation of consent stock.* A corporation is not entitled to a consent dividends credit for any taxable year in which it has taken any steps in, or in pursuance of a plan of, complete or partial liquidation of all or any part of the consent stock.

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has outstanding on January 1, 1939, 1,000 shares of class A stock, the dividend rights of which are limited to an annual return of $6 per share. It also has outstanding on that date 1,000 shares of class B stock, which is entitled to receive the entire amount of any distribution made of earnings or profits within the taxable year after the payment on class A of $6 per share. On April 1, 1939, the corporation makes a distribution in partial liquidation, whereby five shares of class B stock (consent stock) are canceled or redeemed. The corporation is barred from obtaining a consent dividends credit for the taxable year, regardless of compliance with other requirements of section 28. If, however, class A stock (not consent stock), instead of class B stock, had been canceled or redeemed in the liquidation, the corporation would not be barred, because of such liquidation, from obtaining a consent dividends credit.

The mere purchase by a corporation of its own stock for investment is not, within the meaning of section 28 (b) (2), the taking of any step in, or in pursuance of a plan of, complete or partial liquidation and will not prevent a corporation from obtaining a consent dividends credit for the taxable year.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(c) *Allowance of credit.* There shall be allowed to the corporation, as a part of its basic surtax credit for the taxable year, a consent dividends credit equal to such portion of the total sum agreed to be included in the gross income of shareholders by their consents filed under subsection (d) as it would have been entitled to include in computing its basic surtax credit if actual distribution of an amount equal to such total sum had been made in cash and each shareholder making such a consent had received, on the consent dividends day, the amount specified in the consent.

§ 19.28 (c)-1 *Amount of consent dividends credit.* The consent dividends credit forms part of the basic surtax credit (see section 27 (b) (1). It consists of the amount which the corporation would be permitted to include in its basic surtax credit as a dividend paid if it had distributed to each shareholder whose consent has been filed pursuant to section 28 (d), and each such shareholder had received, on the consent dividends day (see section 28 (a) (3), an amount equal to the amount specified in such consent. The amount of the consent dividends credit, therefore, cannot exceed the sum of the amounts specified in the several consents. It may, however, regardless of the fact that such amounts are treated and taxed in their entirety to the consenting shareholders as a dividend (see section 28 (f)), be smaller than the sum of the specified amounts, because it is limited to the amount which would have been allowed as dividends paid if an actual distribution had been made.

The provisions of section 28 (c) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year. Its earnings and profits for the calendar year 1939 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1939. The sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X Corporation on December 31, 1939, only $8,000 would have constituted a dividend. The allowance for dividends paid, includible in the computation of the basic surtax credit, would have amounted to only $8,000. The consent dividends credit of the corporation, therefore, is limited to $8,000.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(d) *Shareholders' consents.* The corporation shall not be entitled to a consent dividends credit with respect to any taxable year—

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

(2) Unless in each such consent the shareholder agrees that he will include as a taxable dividend, in his return for the taxable year in which or with which the taxable year of the corporation ends, a specific amount; and

(3) Unless the consents filed are made by such of the shareholders and the amount specified in each consent is such, that the consent distribution would not have been a preferential distribution—

(A) If there was no partial distribution during the last month of the taxable year of the corporation, or

(B) If there was such a partial distribution, then when considered in connection with such partial distribution;

and

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

(5) Unless each consent filed is accompanied by cash, or such other medium of payment as the Commissioner may by regulations authorize, in an amount equal to the amount that would be required by section 143 (b) or 144 to be deducted and withheld by the corporation if the amount specified in the consent had been, on the last day of the taxable year of the corporation, paid to the shareholder in cash as a dividend. The amount accompanying the consent shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.

§ 19.28 (d)–1 *Making and filing of consents.* A consent shall be made in duplicate on oath or affirmation on Form 972 in accordance with these regulations and the instructions on the form or issued therewith and may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, i. e., the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. In the consent such person must agree:

(1) to include in his gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend; and

(2) if he is a shareholder who is taxable with respect to a dividend only if received from sources within the United States, that the specific amount stated in his consent shall be considered as a dividend received by him from sources within the United States.

A consent may be made at any time not later than the due date of the corporation's income tax return for the taxable year for which the credit is claimed. (See section 19.53–4.) With such return, and not later than the due date thereof, the corporation must file two duly executed duplicate originals of each consenting shareholder's consent, and a return on oath or affirmation on Form 973, showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distribution made during the taxable year to shareholders, and giving all the other information required by the form.

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

(a) cash;

(b) United States postal money order;

(c) certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(d) a cashier's check of a domestic bank; or

(e) a draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed by section 211 (a) or 231 (a) upon the shareholder.*

§ 19.28 (d)–2 *Consent distribution must be nonpreferential.* The application of section 23 (d) (3) may be illustrated as follows:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1939, the corporation distributes $600 to B and $100 to A. On December 31, 1939, A executes a consent to include $500 in his gross income as a taxable dividend, though such amount is not distributed to him. The X Corporation, assuming the other requirements of section 28 have been complied with, is entitled to a consent dividends credit of $500. Though considered by themselves, both the partial distribution of $700 and the consent distribution of $500 are preferential, when considered together they constitute a single nonpreferential distribution of $1,200.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(e) *Consent distribution as part of entire distribution.* If during the last month of the taxable year with respect to which shareholders' consents are filed by the corporation under subsection (d) there is made a partial distribution, then, for the purposes of this chapter, such partial distribution and the consent distribution shall be considered as having been made in connection with each other and each shall be considered together with the other as one entire distribution.

§ 19.28 (e)–1 *Consent and partial distributions to be considered together.* The rule provided in section 28 (e), that a consent distribution and a partial distribution are to be considered as having been made in connection with each other and as together forming parts of one entire distribution, is not limited to the purposes of section 28, but is applicable in connection with any of the purposes of chapter 1. Thus, such rule is to be applied to determine whether a partial distribution is a preferential dividend under section 27 (h). See section 19.27 (h)–1.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(f) *Taxability of amounts specified in consents.* The total amount specified in a consent filed under subsection (d) shall be included as a taxable dividend in the gross income of the shareholder making such consent, and, if the shareholder is taxable with respect to a dividend only if received from sources within the United States, shall be included in the computation of his tax as a dividend received from sources within the United States; regardless of—

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

(2) Whether the distribution by the corporation of an amount equal to the total sum included in all the consents filed, had actual distribution been made, would have been in whole or in part a taxable dividend; and

(3) Whether the corporation is entitled to any consent dividends credit by reason of the filing of such consents, or to a credit less than the total sum included in all the consents filed.

§ 19.28 (f)-1 *Taxability of amounts specified in consents.* Once a shareholder's consent is filed, the full amount specified therein shall be included in his gross income as a taxable dividend, and, in cases where the shareholder is taxable on a dividend only if received from sources within the United States, shall be treated as a dividend so received; regardless of—

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

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

(3) whether the corporation, as a result of filing such consents, is entitled to any consent dividends credit or to a smaller consent dividends credit than the sum of the amounts specified in the several consents.

The ground upon which a consent dividends credit is denied the corporation does not affect the taxability to a shareholder whose consent has been filed of the amount specified in his consent. Thus, he is taxable on the full amount so specified, though the corporation receives no credit or a smaller credit than the sum of the amounts specified in the consents because the corporation has no earnings and profits or a smaller amount of earnings and profits than the sum of the amounts specified in the consents. The full amount specified in a shareholder's consent which has been filed is also taxable to him as a dividend though a consent dividends credit is denied the corporation because (a) preferred dividends have not been paid, (b) part or all of the consent stock has been in a state of liquidation at any time during the taxable year, (c) the distribution of which the consent distribution is a part is preferential, (d) a consenting shareholder who is taxable with respect to a dividend only if received from sources within the United States fails to agree that the amount specified in his consent shall be considered as a dividend received by him from sources within the United States, or (e) payment has not been made as required by section 28 (d) (5) and section 19.28 (d)-1.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(g) *Corporate shareholders.* If the shareholder who makes the consent is a corporation, the amount specified in the consent shall be considered as part of its earnings or profits for the taxable year, and shall be included in the computation of its accumulated earnings and profits.

§ 19.28 (g)-1 *Treatment of amount specified in consent of corporate shareholder.* From the standpoint of computing a shareholder's income for a taxable year relative to which he has agreed to include a specific amount in gross income, such amount is treated exactly as though such shareholder had received in cash a taxable dividend equal to the amount specified in his consent. Therefore, in the case of a corporate shareholder, such amount shall be included in the computation of its earnings and profits for the taxable year and its accumulated earnings and profits as of the close of the taxable year. The effect of a corporate shareholder's consent upon the computation of its earnings and profits may be illustrated as follows:

Example. The X Corporation has one shareholder, the Y Corporation, whose consent to include $10,000 in its gross income for the calendar year 1939 has been duly made and filed. The earnings and profits of the X Corporation for the calendar year 1939 amount to only $8,000, there being at the beginning of such year no accumulated earnings or profits. The Y Corporation must nevertheless include in its gross income $10,000 as a taxable dividend. Assume the Y Corporation to have begun the year 1939 with $5,000 accumulated earnings and profits, to have made no distributions during the year, and (without considering the amount specified in its consent) to have had neither profit nor loss during the year. Its earnings and profits for the year will be $10,000 and its accumulated earnings and profits at the close of the year will be $15,000.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(h) *Basis of stock in hands of shareholders.* The amount specified in a consent made under subsection (d) shall, for the purpose of adjusting the basis of the consent stock with respect to which the consent was given, be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only in an amount which bears the same ratio to the consent dividends credit of the corporation as the amount of such shareholder's consent stock bears to the total amount of consent stock with respect to which consents are made.

(i) *Effect on capital account of corporation.* The amount of the consent dividends credit allowed under subsection (c) shall be considered as paid in surplus or as a contribution to the capital of the corporation, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced.

§ 19.28 (i)-1 *Effect on basis of stock in hands of shareholders and capital account of corporation.* The application of sections 28 (h) and 28 (i) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned entirely by A and B in equal amounts. A makes a consent to include $50 in his gross income as a dividend, but B refuses to do so. The X Corporation therefore distributes $50 to B in cash during the last month of its taxable year 1939. The consent distribution evidenced by A's consent and the actual distribution to B are treated together, as though one distribution of $100 had been made. The earnings and profits of the X Corporation for 1939, however, amount to only $80, there being at the beginning of such year no accumulated earnings or profits. If, therefore, the entire $100, which is the sum of A's consent distribution and B's actual distribution, had been actually distributed, 80 percent thereof would have been a dividend, includible in the X Corporation's basic surtax credit, and 20 percent a return of capital. Applying this principle to the facts stated, the following results are obtained:

(1) In the case of the X Corporation—

(a) Its consent dividends credit is $40, being 80 percent of the amount specified in A's consent;

(b) Its basic surtax credit, assuming it has no net operating loss in the preceding year and no bank affiliate credit, is $80, composed of a consent dividends credit of $40 and an allowance for dividends paid of $40;

(c) The amount of its accumulated earnings and profits as of the close of the taxable year is zero, because of the transfer of $40 (the amount of the consent dividends credit) from earnings and profits to capital account and the deduction of an additional $40 on account of dividends paid to B. If, therefore, in the following year the X Corporation has no earnings and profits but nevertheless makes a distribution to shareholders, no part of such distribution will be a dividend, but it will all constitute a return of capital.

(2) In the case of A—

(a) A is taxable on $50 as a dividend;

(b) The basis of his stock is increased by $40, his pro rata share, i. e., all, of the consent dividends credit.

(3) In the case of B—

(a) B is taxable on $40 as a dividend;

(b) The basis of his stock is reduced by $10.*

[SEC. 28. CONSENT DIVIDENDS CREDIT.]

(j) *Amounts not included in shareholder's return.* The failure of a shareholder of consent stock to include in his gross income for the proper taxable year the amount specified in the consent made by him and filed by the corporation, shall have the same effect, with respect to the deficiency resulting therefrom, as is provided in section 272 (f) with respect to a deficiency resulting from a mathematical error appearing on the face of the return.

Credits Against Tax

SEC. 31. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

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

SEC. 32. TAXES WITHHELD AT SOURCE.

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

SEC. 33. CREDIT FOR OVERPAYMENTS.

For credit against the tax of overpayments of taxes imposed by this chapter for other taxable years, see section 322.

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).

§ 19.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 19.42-1 to 19.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.*

§ 19.41-2 *Bases of computation and changes in accounting methods.* Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 19.42-2 and 19.42-3.) 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 section 19.22 (c)-5.)

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

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see sections 19.22 (c)-1 to 19.22 (c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see section 19.42-4); 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 sections 19.22 (a)-7 and 19.23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22 (d) and regulations thereunder with respect to changing to optional method of inventorying goods.

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

The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in section 19.44-1, 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.*

§ 19.41-3 *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 section 19.54-1.) Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, 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 sections 19.22 (c)-1 to 19.22 (c)-8, inclusive);

(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.*

§ 19.41-4 *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 section 19.46-1.*

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.

§ 19.42-1 *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 sections 19.41-1 to 19.41-3, inclusive.) 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 section 19.23 (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.*

§ 19.42-2 *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.*

§ 19.42-3 *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.*

§ 19.42-4 *Long-term contracts.* Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

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

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 19.41-2.*

§ 19.42-5 *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 corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death (except deductions under section 23 (o)) if not otherwise properly allowable in respect of such period or a prior period.

§ 19.43–1 *"Paid or incurred" and "paid or accrued."*

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

(b) The provisions of paragraph (a) of this section 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 (except deductions under section 23 (o)) 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.*

§ 19.43–2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.*

SEC. 44. INSTALLMENT BASIS.

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

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

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

(d) *Gain or loss upon disposition of installment obligations.* If an installment obligation is satisfied at other than its face value, or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties, as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. If an installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and under section 112 (b) (6) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation, then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation.

[1] So in original.

§ 19.44-1 *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 section.

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

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also section 19.44-5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession, unless it is clearly shown that after the property was repossessed the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the repossession. (See also section 19.23 (k)-1.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The property repossessed shall be carried on the books of the vendor at its fair market value at the time of repossession.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible.*

§ 19.44-2 *Sale of real property involving deferred payments.* Under section 44 deferred-payment sales of real property include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (b) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments. Such sales, either under (a) or (b), fall into two classes when considered with respect to the terms of sale, as follows:

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

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

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in sections 19.44-1 and 19.44-3, and in this section. The term "initial payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "selling price." The term "initial payments" contemplates at least one other payment in addition to the initial payment. If the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.*

§ 19.44-3 *Sale of real property on installment plan.* In transactions included in class (1) in section 19.44-2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If the purchaser defaults in any of his payments, and the vendor returning income on the installment basis reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. (See also section 19.44–5.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquistion of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. (See section 19.23 (k)–1.) If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.*

§ 19.44–4 *Deferred-payment sale of real property not on installment plan.* In transactions included in class (2) in section 19.44–2, 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.*

§ 19.44–5 *Gain or loss upon disposition of installment obligations.* The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations, computed in accordance with section 44 (d), is recognized under the Internal Revenue Code, unless the disposition is within one of the exceptions made by the Code. Such an exception is provided in section 44 (d) with respect to distributions under section 112 (b) (6), and in section 112 (b) (4) and (5) with respect to exchanges.

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

Example (1). In 1937 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1918 at a cost of $10,000. During 1937 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 1939, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1939 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 1939		5,500

Example (2). Suppose in the example given above the M Corporation, instead of selling the notes, distributed them in 1939 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 1939 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 1939	6,500

If the taxpayer, referred to in the above examples (1) and (2) as Corporation M, had been an individual, the taxable income to be reported, shown above as $5,500 and $6,500, respectively, would have been limited to 50 percent thereof by section 117 (b), the real estate having been held for more than 24 months prior to its sale in 1937. See also section 117 (c).

In the case of a decedent who dies possessed of installment obligations, no gain on account of the transmission at death of such obligations is required to be reported as income in the return of the decedent for the year of his death, if the executor or administrator of the estate of the decedent or any of the next of kin or legatees files with the Commissioner a bond on Form 1132 conditioned upon the return as income, by any person receiving any payment in satisfaction of such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and received such payment. The bond shall be subject to the approval of the Commissioner, shall be in an amount sufficient in his judgment to insure collection of the tax resulting from the fulfillment of the conditions stated in the bond, and shall be filed at the time of filing the return for the decedent for the year of his death or at such later time as may be specified by the Commissioner. The bond on Form 1132 may be (1) executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, or (2) secured by deposit of bonds or notes of the United States, or the installment obligations, in such amounts as the Commissioner may deem necessary to insure collection of the tax.

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.

§ 19.45–1 *Determination of the taxable net income of a controlled taxpayer.*

(a) *Definitions.* When used in this section—

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

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

(3) The term *"controlled"* includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term *"controlled taxpayer"* means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms *"group"* and *"group of controlled taxpayers"* mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term *"true net income"* means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

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

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

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

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

SEC. 46. CHANGE OF ACCOUNTING PERIOD.

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

§ 19.46–1 *Change of 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.

§ 19.47-1 *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 chapter—

(a) *Taxable year.* "Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part.[1] "Taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this chapter or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

(b) *Fiscal year.* "Fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.

(c) *"Paid or incurred", "paid or accrued".* The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.[1]

(d) *Trade or business.* The term "trade or business" includes the performance of the functions of a public office.

Returns and Payment of Tax

SEC. 51. INDIVIDUAL RETURNS.

(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 chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual who is single or who is married but not living with husband or wife, if—

(A) Having a net income for the taxable year of $1,000 or over: or

(B) Having a gross income for the taxable year of $5,000 or over, regardless of the amount of the net income.

(2) Every individual who is married and living with husband or wife, if no joint return is made under subsection (b) and if—

(A) Such individual has for the taxable year a net income of $2,500 or over or a gross income of $5,000 or over (regardless of the amount of the net income), and the other spouse has no gross income; or

(B) Such individual and his spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate net income of the two is $2,500 or over; or

(C) Such individual and his spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate gross income is $5,000 or over.

(b) *Husband and wife.* In the case of a husband and wife living together the income of each (even though one has no gross income) may be included in a single return made by them jointly, in which case the tax shall be computed on the aggregate income, and the liability with respect to the tax shall be joint and several. No joint return may be made if either the husband or wife is a nonresident alien.

(c) *Persons under disability.* If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

(d) *Signature presumed correct.* The fact that an individual's name is signed to a filed return shall be prima facie evidence for all purposes that the return was actually signed by him.

(e) *Fiduciaries.* For returns to be made by fiduciaries, see section 142.

§ 19.51-1 *Individual returns.*

(a) *In general.* For each taxable year a return of income shall be made by each citizen of the United States, whether residing at home or abroad, and every individual residing within the United States though not a citizen thereof, whether or not such citizen or resident is the head of a family or has dependents—

(1) If single or married but not living with husband or wife for any part of the taxable year, and if—

(a) having for the taxable year a gross income (as defined in sections 22 and

[1] This Part comprises sections 41 to 48, inclusive.

116) of $5,000 or over (regardless of the amount of the net income); or

(b) having for the taxable year a net income (as defined in section 21) of $1,000 or over.

(2) If married and living with husband or wife for the entire taxable year, if no joint return is made, and if—

(a) having for the taxable year a net income of $2,500 or over or a gross income of $5,000 or over (regardless of the amount of the net income), and the other spouse has no gross income; or

(b) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate net income of the two is $2,500 or over; or

(c) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income) and the aggregate gross income is $5,000 or over.

(3) If married and living with husband or wife for any part of the taxable year but not at the close thereof, or if married and living with husband or wife at the close of the taxable year, but not during the entire taxable year, if no joint return is made, and if—

(a) having for the taxable year a net income equal to, or in excess of, the credit allowed him or her by section 25 (b) (1) and (3) (computed without regard to any credit to which he or she may be entitled as the head of a family (see section 19.25-7)), or a gross income of $5,000 or over (regardless of the amount of the net income) and the other spouse has no gross income; or

(b) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income), and the aggregate net income of the two is equal to, or in excess of, the credit allowed them by section 25 (b) (1) and (3) (computed without regard to any credit to which either or both may be entitled as the head of a family (see section 19.25-7)); or

(c) such individual and his or her spouse each has for the taxable year a gross income (regardless of the amount of the net income), and their aggregate gross income is $5,000 or over.

(b) *Joint returns.* A husband and wife, if living together at the close of the taxable year, may elect to make a joint return (see section 51 (b), that is, to include in a single return made by them jointly the income and deductions of each, even though one has no gross income. In such a case, the tax shall be computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year. A joint return may not be made if either the husband or wife is a nonresident alien.

A joint return of a husband and wife (if not made by an agent other than husband or wife, see section 19.51-2) shall be signed by both spouses, except that one spouse may sign the return as the agent for the other, if the return is accompanied by a power of attorney on Form 936, authorizing such action. The spouse acting as agent shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

The joint return of a husband and wife shall be sworn to before a person duly authorized to administer oaths (see section 19.51-4) 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 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 section 19.51-2.

For returns by fiduciaries, see section 142; by partnerships, see section 187; and by nonresident alien individuals, see section 217. For time and place for filing returns, see section 53.*

§ 19.51-2 *Form of return.* The return shall be on Form 1040 except that it shall be on short Form 1040A if (1) the net income does not exceed $5,000, and is derived from interest, dividends, annuities, income from fiduciaries, and salaries, wages, commissions, bonuses, and other compensation for personal services, and (2) the taxpayer does not own a business or practice a profession on his own account and renders a return on the cash receipts and disbursements basis for the calendar year. The return shall be made on Form 1040 in all cases in which the taxpayer claims any deductions for losses from the renting of, or sale or exchange of, property. The forms may be had from the collectors of the several districts. The return may be made by an agent if, by reason of illness, the person liable for the making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States for a period of at least 60 days prior to the date prescribed by law for making the return. Whenever a return is made by an agent it must be accompanied by the prescribed power of attorney, Form 935. 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 sections 19.217-1 and 19.217-2.

The home or residential address of the taxpayer (including the street and number, if any) shall be given in the space provided at the top of the return for the name and address of the taxpayer. A taxpayer having a permanent business address may give that address as the principal or mailing address, provided that the complete home or residential address is also given within the space provided.*

§ 19.51-3 *Return of income of minor.* An individual, although a minor, who is single, is required to render a return of income if he has a net income of his own of $1,000 or over, or a gross income of $5,000 or over, for the taxable year. If the aggregate of the net income of such a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings which belong to him, is at least $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 section 19.142-2.) If he is married, see section 19.51-1. If under the laws of a State the earnings of a minor belong to the minor, such earnings, regardless of amount, are not required to be included in the return of the parent. In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return.*

§ 19.51-4 *Verification of returns.*

(a) All income tax returns must be verified under oath or affirmation. The oath or affirmation may be administered by any person duly authorized to administer oaths for general purposes by the law of the United States or of any State, Territory, or possession of the United States, or of the District of Columbia, wherein such oath or affirmation is administered, or by a consular officer of the United States. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those respective services. Income tax returns executed abroad may be attested free of charge before United States consular officers. If a foreign notary or other foreign official having no seal should act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer.

(b) If any person or persons actually prepare an income return for another person, the prescribed form of affidavit on the return shall be subscribed and sworn to by such person or persons preparing the return. Such affidavit is required on all income returns required under the Internal Revenue Code except the following:

(1) Returns required to be made by individuals on Form 1040A;

(2) Returns required under sections 143 and 144 (relating to withholding of tax at the source);

(3) Returns required to be made by departing aliens under section 146;

(4) Returns required under sections 147, 148, and 149 (relating to information at source);

(5) Returns by subsidiary corporations included in consolidated returns; and

(6) Returns required under sections 338 (a), 339, and 3604 (relating to monthly information returns filed by officers and directors, and also monthly and annual information returns filed by certain shareholders, of certain foreign corporations, and returns as to the formation of foreign corporations). (See paragraph 107 of the Appendix to these regulations.)

Such affidavit is not required if the actual preparation of the return is a regular and usual incident of the employment of one regularly and continuously employed for full time by the person for whom the return is made (as in the case of a clerk, secretary, bookkeeper, accountant, etc.). If, however, the employee is not regularly or continuously employed by the person for whom the return is made for the full time, or the actual preparation of the return is not a regular and usual incident of such employment, the requirements of this paragraph apply. Thus, if the return is prepared by an accountant or firm of accountants making periodical audits of the accounts of the person for whom the return is prepared, the affidavit is required. If the return is a separate return of a married person, the affidavit is required, although the one actually preparing the return is the husband or wife of the taxpayer. A person who renders mere mechanical assistance or preparation as, for example, a stenographer or typist, is not considered as preparing the return. If, in the course of his official duties, a deputy collector, an internal revenue agent, or other officer or employee of the Bureau of Internal Revenue actually prepares the return, the person for whom the return is made shall make in the return a brief statement to that effect, and it will not be necessary to make the sworn statement required by this paragraph.*

§ 19.51-5 *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified, and filed with the collector on or before the due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Returns which have not been so prepared will not be accepted as meeting the requirements of the Internal Revenue Code. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time the statement so made will relieve the taxpayer from liability to penalties; *Provided* That without unnecessary delay such a tentative return is supplemented by a return made on the proper form. (See further sections 19.53-2 to 19.53-4, inclusive.)*

SEC. 52. CORPORATION RETURNS.

(a) *Requirement.* Every corporation subject to taxation under this chapter shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

(b) *Cross reference.* For provisions as to consolidated returns in the case of railroad corporations, see section 141.

§ 19.52-1 *Corporation returns.* Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations, the return shall be on Form 1120 or Form 1120A. For returns of insurance companies, see sections 19.201 (b)-1, 19.204 (a)-1, and 19.207-7; of foreign corporations, see section 235; and of affiliated corporations, see section 141 and section 19.141-1. 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 1939 prior to the enactment of the Internal Revenue Code is not relieved from the necessity of rendering returns thereunder for any period or periods of its existence for which the Code is effective. For information returns by corporations contemplating dissolution or liquidation, see section 148 (d). For information returns by corporations of distributions in liquidation, see section 148 (e). For information returns by corporations relating to profits of the taxable year declared as dividends, see section 148 (b). For verification of returns and use of prescribed forms, see sections 19.51-4 and 19.51-5.*

§ 19.52-2 *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 sections 19.274-1 and 19.274-2.) 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.

§ 19.53-1 *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. See also section 148 (d) and (e).*

§ 19.53-2 *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 sections 19.53-3, 19.56-2, and 19.272-3.*

§ 19.53-3 *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, 1938, 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.*

§ 19.53-4 *Due date of return.* The due date is the date on or before which a return is required to be filed in accordance with the provisions of the Internal Revenue Code 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, section 291.*

§ 19.53-5 *Place for filing individual returns.* Section 53 (b) (1) provides that individual returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Md.

An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of section 53 (b) (1), and shall make his return to the collector for the district in which is located his legal residence, or, if he has no legal residence in the United States, then to the collector at Baltimore, Md.*

SEC. 54. RECORDS AND SPECIAL RETURNS.

(a) *By taxpayer.* Every person liable to any tax imposed by this chapter or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

(b) *To determine liability to tax.* Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return, render under oath such statements, or keep such records, as the Commissioner deems sufficient to show whether or not such person is liable to tax under this chapter.

(c) *Information at the source.* For requirement of statements and returns by one person to assist in determining the tax liability of another person, see sections 147 to 150.

(d) *Copies of returns.* If any person, required by law or regulations made pursuant to law to file a copy of any income return for any taxable year, fails to file such copy at the time required, there shall be due and assessed against such person $5 in the case of an individual return or $10 in the case of a fiduciary, partnership, or corporation return, and the collector with whom the return is filed shall prepare such copy. Such amount shall be collected and paid, without interest, in the same manner as the amount of tax due in excess of that shown by the taxpayer upon a return in the case of a mathematical error appearing on the face of the return. Copies of returns filed or prepared pursuant to this subsection shall remain on file for a period of not less than two years from the date they are required to be filed, and may be destroyed at any time thereafter under the direction of the Commissioner.

(e) *Foreign personal holding companies.* For information returns by officers, directors, and large shareholders, with respect to foreign personal holding companies, see sections 338, 339, and 340.

For information returns by attorneys, accountants, and so forth, as to formation, and so forth, of foreign corporations, see section 3604.

§ 19.54-1 *Records and income tax forms.* Every person subject to the tax, except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1. Such books or records shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

Income-tax forms shall be prescribed by the Commissioner and shall be executed and filed in accordance with these regulations and the instructions on the form or issued therewith.*

SEC. 55. PUBLICITY OF RETURNS.

(a) *Public record and inspection.*

(1) Returns made under this chapter upon which the tax has been determined by the Commissioner shall constitute public records; but, except as hereinafter provided in this section, they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President.

(2) And all returns made under this chapter, subchapters A, B, and D of chapter 2, subchapter B of chapter 3, chapters 4, 7, 12, and 21, subchapter A of chapter 29 and subchapters A and B of chapter 30, shall constitute public records and shall be open to public examination and inspection to such extent as shall be authorized in rules and regulations promulgated by the President.

(3) Whenever a return is open to the inspection of any person a certified copy thereof shall, upon request, be furnished to such person under rules and regulations prescribed by the Commissioner with the approval of the Secretary. The Commissioner may prescribe a reasonable fee for furnishing such copy.

(b) *Inspection by States.*

(1) *State officers.* The proper officers of any State may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe.

(2) *State bodies or commissions.* All income returns filed under this chapter (or copies thereof, if so prescribed by regulations made under this subsection), shall be open to inspection by any official, body, or commission, lawfully charged with the administration of any State tax law, if the inspection is for the purpose of such administration or for the purpose of obtaining information to be furnished to local taxing authorities as provided in this paragraph. The inspection shall be permitted only upon written request of the governor of such State, designating the representative of such official, body, or commission to make the inspection on behalf of such official, body, or commission. The inspection shall be made in such manner, and at such times and places, as shall be prescribed by regulations made by the Commissioner with the approval of the Secretary. Any information thus secured by any official, body, or commission of any State may be used only for the administration of the tax laws of such State, except that upon written request of the Governor of such State any such information may be furnished to any official, body, or commission of any political subdivision of such State, lawfully charged with the administration of the tax laws of such political subdivision, but may be furnished only for the purpose of, and may be used only for, the administration of such tax laws.

(c) *Inspection by shareholders.* All bona fide shareholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries.

(d) *Inspection by committees of Congress.*

(1) *Committees on ways and means and finance.*

(A) The Secretary and any officer or employee of the Treasury Department, upon request from the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, or a select committee of the Senate or House specially authorized to investigate returns by a resolution of the Senate or House, or a joint committee so authorized by concurrent resolution, shall furnish such committee sitting in executive session with any data of any character contained in or shown by any return.

(B) Any such committee shall have the right, acting directly as a committee, or by or through such examiners or agents as it may designate or appoint, to inspect any or all of the returns at such times and in such manner as it may determine.

(C) Any relevant or useful information thus obtained may be submitted by the committee obtaining it to the Senate or the House, or to both the Senate and the House, as the case may be.

(2) *Joint Committee on Internal Revenue Taxation.* The Joint Committee on Internal Revenue Taxation shall have the same right to obtain data and to inspect returns as the Committee on Ways and Means or the Committee on Finance, and to submit any relevant or useful information thus obtained to the Senate, the House of Representatives, the Committee on Ways and Means, or the Committee on Finance. The Committee on Ways and Means or the Committee on Finance may submit such information to the House or to the Senate, or to both the House and the Senate, as the case may be.

(e) *Inspection in collector's office of list of taxpayers.* The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal revenue district and in such other places as he may determine, lists containing the name and the post-office address of each person making an income-tax return in such district.

(f) *Penalties for disclosing information.*

(1) *Federal employees and other persons.* It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

(2) *State employees.* Any officer, employee, or agent of any State or political subdivision, who divulges (except as authorized in paragraph 2 of subsection (b), or when called upon to testify in any judicial or administrative proceeding to which the State or political subdivision, or such State or local official, body, or commission, as such, is a party) any information acquired by him through an inspection permitted him or another under paragraph 2 of subsection (b) shall be guilty of a misdemeanor and shall upon conviction be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both.

(3) *Shareholders.* Any shareholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both.

(4) *Cross reference.* For penalties for disclosing operations, style of work, or apparatus of any manufacturer or producer, see section 4047.

§ 19.55 (b)-1 *Definitions.* Any word or term used in this section and sections 19.55 (b)-2 to 19.55 (b)-5, inclusive, which is defined in any chapter of the Internal Revenue Code shall be given the definition contained in the chapter which is applicable with respect to the particular return made.*

§ 19.55 (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 gf sections 51, 52, 141, 142, or 187, or sections 500 to 511, inclusive, 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 H-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 filing 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).*

§ 19.55 (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.*

§ 19.55 (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.*

§ 19.55 (b)-5 *Inspection of original returns.* In addition to the inspection of copies of returns provided for in section 19.55 (b)-3, any properly authorized official, body, or commission, lawfully charged with the administration of any State tax law, or properly designated representatives of such official, body, or commission, may, in the discretion of the Commissioner, inspect original income returns for any taxable year ending on or after July 31, 1939, for the purpose of such administration. For the purposes of this section the word "returns" shall include information returns, schedules, lists, and other written statements filed with the Commissioner designed to be supplemental to or to become a part of income returns. When permission to inspect original returns is requested, the application of the governor of the State shall conform to the requirements specified in section 19.55 (b)-4.

In any case where inspection of the original returns is authorized in accordance with the provisions of this section, the Commissioner may, in his discretion, permit inspection of other records and reports which contain information included or required by statute to be included in the return.

For inspection of returns, other than on behalf of States or political subdivisions thereof, and furnishing copies of returns so open to inspection, see Treasury Decision 4929, approved by the President on August 28, 1939, and Treasury Decision 4945, approved September 20, 1939 (see paragraph 110 of the Appendix of these regulations).*

SEC. 56. PAYMENT OF TAX.

(a) *Time of payment.* The total amount of tax imposed by this chapter shall be paid on the fifteenth day of March following the close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the third month following the close of the fiscal year.

(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.*

(1) *General rule.* At the request of the taxpayer, the Commissioner may extend the time for payment of the amount determined as the tax by the taxpayer, or any installment thereof, for a period not to exceed six months from the date prescribed for the payment of the tax or an installment thereof. In such case the amount in respect of which the extension is granted shall be paid on or before the date of the expiration of the period of the extension.

(2) *Liquidation of personal holding companies.* At the request of the taxpayer, the Commissioner may (under regulations prescribed by the Commissioner with the approval of the Secretary) extend (for a period not to exceed five years from the date prescribed for the payment of the tax) the time for the payment of such portion of the amount determined as the tax by the taxpayer as is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c)) of a corporation. This paragraph shall apply only if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in such section), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension under this paragraph shall be granted only if it is shown to the satisfaction of the Commissioner that the failure to grant it will result in undue hardship to the taxpayer. If an extension is granted the amount with respect to which the extension is granted shall be paid on or before the date of the expiration of the extension. If an extension is granted under this paragraph the Commissioner may require the taxpayer to furnish a bond in such amount, not exceeding double the amount with respect to which the extension is granted, and with such sureties as the Commissioner deems necessary, conditioned upon the payment of the amount with respect to which the extension is granted in accordance with the terms of the extension.

(d) *Voluntary advance payment.* A tax imposed by this chapter, or any installment thereof, may be paid, at the election of the taxpayer, prior to the date prescribed for its payment.

(e) *Advance payment in case of jeopardy.* For advance payment in case of jeopardy, see section 146.

(f) *Tax withheld at source.* For requirement of withholding tax at the source in the case of nonresident aliens and foreign corporations, and in the case of so-called "tax-free covenant bonds", see sections 143 and 144.

(g) *Fractional parts of cent.* In the payment of any tax under this chapter a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

(h) *Receipts.* Every collector to whom any payment of any income tax is made shall upon request give to the person making such payment a full written or printed receipt therefor.

§ 19.56-1 *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 section 19.53-3. The tax may, at the option of the taxpayer, be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date. If the taxpayer elects to pay the tax in four installments, each of the four installments must be equal in amount, but any installment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment either by the Internal Revenue Code or by the Commissioner in accordance with the terms of an extension, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector.*

§ 19.56-2 *Extension of time for payment of the tax or installment thereof.* If it is shown to the satisfaction of the Commissioner that the payment of the amount determined as the tax by the taxpayer or any part or installment thereof upon the date or dates prescribed for the payment thereof will result in undue hardship to the taxpayer, the Commissioner, at the request of the taxpayer, may grant an extension of time for the payment for a period not to exceed six months from the date prescribed for the payment of such amount, part, or installment, except that the extension may be for a period not to exceed five years from the date prescribed for the payment of the tax in the case of such portion of the amount determined as the tax by the taxpayer which is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money upon the complete liquidation (as defined in section 115 (c)) of a corporation if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions referred to in section 115 (c)), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the taxpayer from making payment of the amount at the due date. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

An application for an extension of time for the payment of such tax should be made under oath on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A sworn statement of assets and liabilities of the taxpayer and an itemized statement under oath showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax are required and should accompany the application. The application, with the evidence, must be filed with the collector, who will transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner, it will be examined and, if possible, within 30 days will be denied, granted, or tentatively granted, subject to certain conditions of which the taxpayer will be notified. The Commissioner will not consider an application for an extension of time for the payment of a tax unless request therefor is made to the collector on or before the date prescribed for payment of the tax or installment thereof for which the extension is desired, or on or before the date or dates prescribed for payment in any prior extension granted.

As a condition to the granting of such an extension, the Commissioner will usually require the taxpayer to furnish a bond on Form 1130 in an amount not exceeding double the amount of the tax or to furnish other security satisfactory to the Commissioner for the payment of the tax, or installment thereof, on or before the date or dates prescribed for payment in the extension, so that the risk of loss to the Government will not be greater at the end of the extension period than it was at the beginning of the period. If a bond is required it shall be conditioned upon the payment of the tax, interest, and additional amounts assessed in connection therewith in accordance with the terms of the extension granted, and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds, and shall be subject to the approval of the Commissioner. In lieu of such a bond, the taxpayer may file a bond secured by deposit of bonds or notes of the United States equal in their total par value to an amount not exceeding double the amount of the tax, or installment thereof. (See section 1126 of the Revenue Act of 1926, as amended, paragraph 63 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.)*

§ 19.56–3 *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.*

§ 19.56–4 *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.

§ 19.57–1 *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 chapter, 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.

SEC. 60. CROSS REFERENCES.

For general provisions relating to—

(a) Information and returns, see chapter 34.

(b) Assessment, see chapter 35.

(c) Collection, see chapter 36.

Miscellaneous Provisions

SEC. 61. LAWS MADE APPLICABLE.

All administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, shall be extended to and made a part of this chapter.

SEC. 62. RULES AND REGULATIONS.

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

SEC. 63. PUBLICATION OF STATISTICS.

The Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

SEC. 64. DEFINITIONS.

For definitions of a general character, see section 3797.

[*Subpart C, "Supplemental Provisions," will appear in the issue for Friday, February 2, 1940. Subparts D, E, and F will appear in the issue for Saturday, February 3, 1940.*]

[SEAL] GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved, January 29, 1940.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

[F. R. Doc. 40-470; Filed, January 30, 1940; 3:48 p. m.]

TITLE 42—PUBLIC HEALTH

CHAPTER I—UNITED STATES PUBLIC HEALTH SERVICE

[Amendment No. 19]

QUARANTINE REGULATIONS OF THE UNITED STATES

ISSUANCE OF BILLS OF HEALTH

Paragraph 4 of the quarantine regulations of the United States (42 CFR 11.21) is hereby amended to read as follows:

§ 11.21 *Inspection of vessels bound for United States, possessions, or dependencies.* The officer issuing the bill of health to vessels leaving foreign ports and ports in the possessions or other dependencies of the United States for ports in the United States or its possessions or other dependencies shall satisfy himself, by inspection if necessary, that the conditions certified to therein are true. He is authorized, in accordance with law, to withhold the bill of health until he is satisfied that the vessel, the passengers, the crew, and the cargo have complied with all the quarantine laws and regulations of the United States. However, a bill of health shall not be withheld for the sole reason that a deratization or deratization exemption certificate is not presented. Where a bill of health is issued notwithstanding the failure to present such a certificate, the nonpresentation thereof must be noted on the bill of health. (Sec. 3, 27 Stat. 450; 42 U.S.C. 92)

PAUL V. MCNUTT,
Federal Security Administrator.

JANUARY 26, 1940.

[F. R. Doc. 40-472; Filed, January 31, 1940; 9:48 a. m.]

TITLE 47—TELECOMMUNICATION

CHAPTER I—FEDERAL COMMUNICATIONS COMMISSION

PART 3—RULES GOVERNING STANDARD BROADCAST STATIONS

The Commission on January 30, 1940, effective immediately, suspended the operation of Section 3.34[1] of its Rules and Regulations until further order of the Commission.

By the Commission.

[SEAL] T. J. SLOWIE, *Secretary.*

[F. R. Doc. 40-477; Filed, January 31, 1940; 12:16 p. m.]

Notices

DEPARTMENT OF LABOR.

Wage and Hour Division.

NOTICE OF DESIGNATION OF PRESIDING OFFICER FOR HEARING ON MINIMUM WAGE RECOMMENDATIONS OF INDUSTRY COMMITTE NO. 1A FOR THE WOOLEN INDUSTRY

Whereas, the Notice of Hearing[2] on the Minimum Wage Recommendation of Industry Committee No. 1A for the Woolen Industry provided that said hearing will be held before a presiding officer to be designated by the Administrator before February 5, 1940; and

Whereas, the issues to be presented at said hearing have been narrowly confined by Section 8 of the Fair Labor Standards Act of 1938 and by the report and recommendation of Industry Committee No. 1A;

Now, therefore, it is hereby ordered and notice is hereby given that:

1. Thomas Holland be the Presiding Officer at said hearing on the minimum wage recommendation of Industry Committee No. 1A and conduct said hearing in accordance with the rules published in the notice of said hearing; and

2. No intermediate report will be prepared by the Presiding Officer unless so directed by the Administrator, but in lieu thereof, the Presiding Officer shall turn over to the Administrator at the close of the hearing the complete record of the proceedings had before him and the Administrator shall thereafter hear oral argument or accept written briefs upon said record or both as he may determine.

Signed at Washington, D. C., this 30th day of January 1940.

HAROLD D. JACOBS, *Administrator.*

[F. R. Doc. 40-471; Filed, January 30, 1940; 3:50 p. m.]

CIVIL AERONAUTICS AUTHORITY.

Air Safety Board.

[Docket No. 8]

IN THE MATTER OF INVESTIGATION OF ACCIDENT INVOLVING AIRCRAFT NC 18105, WHICH OCCURRED NEAR MOLINE, ILLINOIS, ON JANUARY 12, 1940

NOTICE OF HEARING

An accident involving aircraft of United States registry NC 18105 having occurred near Moline, Illinois, on Friday, January 12, 1940, while such aircraft was being operated in interstate air commerce by United Air Lines Transport Corporation, an air carrier, it is hereby ordered by the Air Safety Board, pursuant to the provisions of Sections 702 (a) (2) and 702 (c) of the Civil Aeronautics Act of 1938, that a public hearing be held in connection with the investigation of said accident on Friday, February 9, 1940, in Room 325 of the United States Post Office Building, 433 West Van Buren Street, Chicago, Illinois, before Examiner Fred M. Glass.

Dated, Washington, D. C., January 30, 1940.

By the Board.

[SEAL] LOUIS R. INWOOD, *Acting Executive Officer.*

[F. R. Doc. 40-469; Filed, January 30, 1940; 2:49 p. m.]

FEDERAL COMMUNICATIONS COMMISSION.

[Docket No. 5813]

IN THE MATTER OF "QUALIFIED TOLL LINE SERVICE" OF THE BELL TELEPHONE COMPANY OF PENNSYLVANIA, SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY, NEW JERSEY BELL TELEPHONE COMPANY, THE MANCHESTER HOME TELEPHONE COMPANY, THE PENNSYLVANIA TELEPHONE CORPORATION, THE EASTERN TELEPHONE AND TELEGRAPH COMPANY

INVESTIGATION AND HEARING

At a session of the Federal Communications Commission held at its office in Washington, D. C., on the 29th day of January, A. D. 1940,

The Commission having under consideration the subjects of the provisions in The Bell Telephone Company of Pennsylvania, Tariff F. C. C. No. 3; the Southern Bell Telephone and Telegraph Company, F. C. C. No. 3; and the New Jersey Bell Telephone Company, Tariff F. C. C. No. 3, governing the furnishing of "Qualified Toll Line Service" between certain points in the operating territory of each company aforesaid in conjunction with the Manchester Home Telephone Company; the Pennsylvania Telephone Corporation, and the Eastern Telephone and Telegraph Company, and the charges, therefor, and the regulations, classifications, and the practices affecting such charges;

It is ordered, That an investigation be, and is hereby instituted by the Federal Communications Commission, on its own motion into and concerning the lawfulness of the maximum, minimum and precise basis of all charges and of the classifications, regulations, and practices relating thereto, applicable to the furnishing of "Qualified Toll Line Service" between certain points in the operating territory of the Southern Bell Telephone and Telegraph Company; The Bell Telephone Company of Pennsylvania and the New Jersey Bell Telephone Company, under the provisions of Tariff F. C. C. No. 3 of the Southern Bell Telephone and Telegraph Company; Tariff F. C. C. No. 3 of the Bell Telephone Company of Pennsylvania and Tariff F. C. C. No. 3 of the New Jersey Bell Telephone Company, respectively, with a view to determining whether the charges and the clasifications, regulations and practices relating thereto, applicable to the furnishing of such services are in any respect in violation of the law, and of making such findings and entering such order or orders in the premises, and of taking such other and further action as the facts and circumstances may appear to warrant;

It is further ordered, That The Bell Telephone Company of Pennsylvania, the Pennsylvania Telephone Corporation, the Southern Bell Telephone and Telegraph Company, the Manchester Home Telephone Company, the New Jersey Bell Telephone Company, the Eastern Telephone and Telegraph Company, and the American Telephone and Telegraph Company be, and are hereby, made respondents to this proceeding, that this order be served upon the respondents, and that notice to the public be given by posting a copy of this order in the office of the Secretary of the Commission; and

It is further ordered, That said proceeding be, and it is hereby assigned for hearing on the 5th day of March, A. D., 1940, at 10:00 a. m., at the office of the Federal Communications Commission, Washington, D. C.

By the Commission.

[SEAL] T. J. SLOWIE, *Secretary.*

[F.R. Doc. 40-478; Filed, January 31, 1940; 12:16 p. m.]

SECURITIES AND EXCHANGE COMMISSION.

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 27th day of January, A. D. 1940.

[File Nos. 51-31, 51-32, 51-33, 51-35]

IN THE MATTER OF UNITED FUEL GAS COMPANY, CUMBERLAND AND ALLEGHENY GAS COMPANY, WARFIELD NATURAL GAS COMPANY, AND THE UNION LIGHT, HEAT AND POWER COMPANY

ORDER APPROVING INTEREST PAYMENTS, ETC.

United Fuel Gas Company, Cumberland and Allegheny Gas Company, Warfield Natural Gas Company, and The Union Light, Heat and Power Company, subsidiaries of Columbia Gas & Electric Corporation, a registered holding company and a subsidiary of The United Corporation, a registered holding company, having filed applications pursuant

[1] 4 F.R. 2717 DI.
[2] 4 F.R. 221 DI.

to Section 12 (c)[1] and Rule U-12C-3 adopted thereunder, for approval of the payment of interest for the three months ending December 31, 1939 on such portions of outstanding 6% Demand Notes of the applicants as were issued as dividends paid out of capital or unearned surplus, or, in the applications of the United Fuel Gas Company and the Cumberland and Allegheny Gas Company alternative orders dismissing the applications, on the ground that the payment of interest and principal on the outstanding 6% Demand Notes is not subject to Rule U-12C-3;

A public hearing on the consolidated applications having been held after appropriate notice;[2] the record in this matter having been examined; and the Commission having made and filed its findings herein;

It is ordered, That the proposed interest payments by United Fuel Gas Company, Cumberland and Allegheny Gas Company, Warfield Natural Gas Company and The Union Light, Heat and Power Company be and the same hereby is approved;

It is further ordered, That United Fuel Gas Company is not required to make further applications to the Commission pursuant to Rule U-12C-3 for continued interest payments on such of its notes as may represent dividends paid out of unearned or capital surplus until applications and declarations now on file with the Commission concerning the funding of its outstanding demand indebtedness are disposed of; that Cumberland and Allegheny Gas Company and Warfield Natural Gas Company are not required to make further applications to the Commission pursuant to Rule U-12C-3 for either continued interest payments or payments of principal on the $4,318.80 and $2,795.78, respectively, of notes which represent dividends paid out of capital or unearned surplus; and that The Union Light, Heat and Power Company may make interest payments on its 6% Demand Notes without application to the Commission pursuant to Rule U-12C-3 on the next quarterly interest payment following the Commission's order in this case, but that unless The Union Light, Heat and Power Company shall have in the meantime filed with this Commission an application for the reduction of its debt by the issuance of common stock as described in the present application, the company shall apply to the Commission pursuant to Rule U-12C-3 for approval of further interest payments.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

[F. R. Doc. 40-473; Filed, January 31, 1940; 12:14 p. m.]

[1] Public Utility Holding Company Act of 1935.
[2] 4 F.R. 5007 DI.

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 30th day of January, A. D. 1940.

[File No. 43-267]

IN THE MATTER OF BROCKTON EDISON COMPANY AND MONTAUP ELECTRIC COMPANY

ORDER CONSENTING TO WITHDRAWAL OF DECLARATION AND APPLICATION

Brockton Edison Company, a subsidiary company of Eastern Utilities Associates, a registered holding company, having filed a declaration pursuant to section 7 of the Public Utility Holding Company Act of 1935, regarding the issuance of its One Year Non-Interest Bearing Unsecured Promissory Note to mature on or about December 30, 1940 to Montaup Electric Company, its subsidiary company; and said Montaup Electric Company having filed an application pursuant to section 10 of said Act for approval of the acquisition of said Note; said companies having now requested leave to withdraw said declaration and application:

It is ordered, That the Commission hereby consents to such withdrawal.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

[F. R. Doc. 40-474; Filed, January 31, 1940; 12:14 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 30th day of January, A. D. 1940.

[File No. 43-271]

IN THE MATTER OF PHILADELPHIA COMPANY

ORDER PERMITTING DECLARATION TO BECOME EFFECTIVE

Philadelphia Company, a registered holding company, having filed a declaration and amendments thereto pursuant to Section 7 of the Public Utility Holding Company Act of 1935 regarding the reduction of the stated value of its common stock from $10.00 per share to $7.25 per share, the creation of a reserve for revaluation of assets, and the transfer to said reserve of the balance of its unsegregated surplus account as of December 31, 1939 and the capital surplus created by the aforementioned reduction of the stated value of its common stock (except not to exceed $5,000,000 of said capital surplus);

Said declaration also providing for an alteration of the voting rights of the security-holders of Philadelphia Company so that if at the date of any annual meeting of stockholders, dividends on the Six Per Cent Cumulative Preferred Capital Stock, or $6.00 or $5.00 Cumulative Preference Stocks are in default, the holders of such of said three classes of preferred stock as are then in default, voting as one class, shall be entitled to elect two members of the Board of Directors, and the holders of the Preferred Five Per Cent Capital Stock and the holders of the Common Capital Stock, also voting as one class, shall be entitled to elect the remaining members of the Board; and that if dividends payable on any one of said three classes of preferred stock shall be in default in an amount equivalent to three full yearly dividends, then the holders of such of said three classes of preferred stock as are at the time in default with respect to any payment of dividends (irrespective of the duration or extent of default as to any said class), voting as one class, shall be entitled to elect the smallest number of directors necessary to constitute a majority of the full Board of Directors, and the holders of the Preferred Five Per Cent Capital Stock and the holders of the Common Capital Stock, also voting as one class, shall be entitled to elect the balance of the Board of Directors;

Said declaration also providing that the proposed transactions will be submitted for the approval of the stockholders of Philadelphia Company in the manner therein described; and that Philadelphia Company will retain in its earned surplus account in each year, beginning with the year 1940, out of earnings for that year which would otherwise be available for dividends on its Common Capital Stock, the amount of $500,000 or its earnings for that year available for such purpose, whichever is lower, until such annual amounts so retained aggregate $2,500,000, and that the amounts so retained shall not be available for dividends on its Common Capital Stock, all until further order of this Commission or until the company shall no longer have any preferred stock (other than Preferred Five Per Cent Capital Stock) outstanding;

Said declaration having also provided for certain credits to capital surplus of Philadelphia Company in the event of sale of any or all shares of the capital stock of the Duquesne Light Company by Philadelphia Company, as more particularly set forth therein, and having made certain other provisions with regard to the accounts of Philadelphia Company and its subsidiary, Duquesne Light Company;

Public hearings having been held on the declaration after appropriate notice;[1] the Declarant having waived a trial examiner's report, the right to submit findings of fact to the Commission, and to have submitted to it proposed findings of fact by counsel to the Commission,

[1] 4 F.R. 4775 DI.

the right to file briefs and the right to oral argument before the Commission; and the Commission having considered the record in this matter and having made and filed its findings herein;

It is ordered, That said declaration be and become effective forthwith subject, however, to the following conditions:

(1) Philadelphia Company will transmit to its stockholders, at the time of solicitation of proxies or assets with regard to the transactions covered by this declaration, copies of the Commission's findings herein, or of such reference thereto as the Commission may approve.

(2) The items reflected in the balance sheet of Philadelphia Company as "Capital Stock Discount and Expense" in the amount of $787,176 and capital stock discount and expense presently included in the amount of $664,768.63 in "Property, Plant and Equipment" shall be eliminated from the balance sheet by a charge against surplus of Philadelphia Company.

(3) Except pursuant to the terms of this order no charges shall be made to Philadelphia Company's "Reserve for Revaluation of Assets" except for losses in and write-downs of investments in street railway companies nor shall any charges be made to "Capital Surplus" arising from the proposed transactions or subsequent transactions, unless (a) such charge has previously been authorized by appropriate resolution of Philadelphia Company's board of directors and (b) subsequent to such resolution of the board of directors, thirty days' prior notice of the making of such charge be given to this Commission. The Commission reserves jurisdiction, on receipt of such notice, in and as part of the proceedings herein, after notice given within such thirty days and opportunity for hearing, to disapprove such charges on the basis of the record herein and any additional evidence that may be adduced by any interested party; and in the event that the Commission shall notify Philadelphia Company to show cause why such charge should not be disapproved, the charge in question shall not be made until expressly authorized by order of this Commission.

(4) The Commission retains and reserves its full jurisdiction herein pursuant to Section 12 (c) and the Rules promulgated thereunder.

(5) The Commission retains and reserves its full jurisdiction herein to act at any time under Section 11 (b) (2) with respect to any unfair or inequitable distribution of voting power whether now existing or hereafter arising.

(6) Within ten days after the completion of the transactions with regard to which the declaration was filed, Philadelphia Company will file with the Commission a certificate of notification, which will be incorporated in the record herein, showing that the said transactions were completed in accordance with the terms and conditions and for the purposes represented by the said declaration.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

[F. R. Doc. 40-475; Filed, January 31, 1940; 12:14 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 31st day of January, A. D. 1940.

[File No. 31-204]

IN THE MATTER OF PUBLIC SERVICE COMPANY OF OKLAHOMA

NOTICE OF AND ORDER FOR HEARING

Public Service Company of Oklahoma, an Oklahoma corporation which is an indirect subsidiary of The Middle West Corporation, a registered holding company, owns in excess of ten (10) per centum of the outstanding voting securities of Southwestern Light & Power Company, a public utility company;

On December 1, 1935 said Public Service Company of Oklahoma filed an application pursuant to section 3 (a) (2) of the Public Utility Holding Company Act of 1935 for exemption as a holding company and for the exemption of said Southwestern Light & Power Company as a subsidiary company of applicant;

By order of March 4, 1936 the Commission directed that a hearing be held on said matter before a Trial Examiner on March 23, 1936 at the Commission's offices in Washington, D. C., pursuant to which order said hearing was convened on said date and thereupon adjourned;

It is ordered, That the hearing on such matter be reconvened on February 20, 1940, at 10:00 o'clock in the forenoon of that day at the Securities and Exchange Building, 1778 Pennsylvania Avenue, NW., Washington, D. C.

It is further ordered, That William W. Swift or any other officer or officers of the Commission designated by it for that purpose shall preside at the hearings in such matter. The officer so designated to preside at any such hearing is hereby authorized to exercise all powers granted to the Commission under section 18 (c) of said Act and to a trial examiner under the Commission's Rules of Practice.

Notice of such hearing is hereby given to such applicant and to any other person whose participation in such proceeding may be in the public interest or for the protection of investors or consumers. It is requested that any person desiring to be heard or to be admitted as a party to such proceeding shall file a notice to that effect with the Commission on or before February 15, 1940.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

[F. R. Doc. 40-476; Filed, January 31, 1940; 12:14 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 31st day of January, A. D. 1940.

[File Nos. 32-169, 44-41]

IN THE MATTER OF THE MARION-RESERVE POWER COMPANY AND UTILITY SERVICE COMPANY

NOTICE OF AND ORDER FOR HEARING

An application or declaration pursuant to Section 6 (b) or 7 (whichever is applicable) of the Public Utility Holding Company Act of 1935 and an application pursuant to Rule U-12C-1 (b) promulgated under the Act having been filed by The Marion-Reserve Power Company with this Commission; the hearing having been set for August 31, 1939 at 10 A. M. of that day at the Securities and Exchange Building, Washington, D. C.; the hearing having been continued subject to call of Trial Examiner; the hearing having been called for February 13, 1940 at 10 A. M. of that day at the Securities and Exchange Building, Washington, D. C.; the Trial Examiner previously designated now being engaged in another matter and unable to preside; an amendment to The Marion-Reserve Power Company's original application or declaration pursuant to Section 6 (b) or 7 (whichever is applicable) of the Act, having been filed with this Commission by The Marion-Reserve Power Company; and a joint application pursuant to Rules U-12C-1 (b), U-12D-1 and U-12F-1 promulgated under the Act, having been filed with this Commission by The Marion-Reserve Power Company and Utility Service Company;

It is ordered, That a hearing on such matters under the applicable provisions of said Act and the rules of the Commission thereunder be held on February 13, 1940, at 10 o'clock A. M. of that day, at the Securities and Exchange Building, 1778 Pennsylvania Avenue, NW., Washington, D. C. On such day the hearing-room clerk in room 1102 will advise as to the room where such hearing will be held. At such hearing, if in respect of any declaration, cause shall be shown why such declaration shall become effective;

It is further ordered, That William W. Swift or any other officer or officers of the Commission designated by it for that purpose shall preside at the hearings in such matters. The officer so designated to preside at any such hearing is hereby authorized to exercise all powers granted to the Commission under Section 18 (c) of said Act and to a trial examiner under the Commission's Rule of Practice.

Notice of such hearing is hereby given to such declarant or applicant and to any other person whose participation in such proceeding may be in the public interest or for the protection of investors or consumers. It is requested that any person desiring to be heard or to be admitted as a party to such proceeding shall file a notice to that effect with the Commission on or before February 8, 1940.

The original application or declaration of the Marion-Reserve Power Company pursuant to Section 6 (b) or 7 (whichever is applicable) of the Act is in regard to the issuance and sale of $7,750,000 principal amount of First Mortgage Bonds, 3½% Series, due September 1, 1950 and $1,250,000 principal amount of Eight-Year 2⅞% promissory notes the proceeds of which will be used for the payment and discharge of the now outstanding First Mortgage Bonds issued by or assumed by The Marion-Reserve Power Company and Serial Notes, in the total principal amount of $8,650,000, and for the reimbursement of its treasury, in part, for expenditures heretofore made for extensions and improvements to its facilities. The Marion-Reserve Power Company applied pursuant to Rule U-12C-1 (b), promulgated under the Act, for approval of the acquisition of $750,000 principal amount of underlying Ohio Electric Power Company's First Mortgage Bonds, 4½% Series, due October 1, 1948 and $600,000 principal amount of its Ten-Year Serial Notes (unsecured) due 1940-47 inclusive.

The amendment filed by the Marion-Reserve Power Company is in regard to a proposal for the issue and sale of 7,500 shares of $5 Preferred Stock (without par value) to the public through underwriters at a price to be stated by further amendment; and 3,000 shares of common stock (without par value) as a common stock dividend to Utility Service Company. It is stated that the net proceeds of the proposed issue of $5 Preferred Stock will be used for physical integration and construction purposes.

It is further proposed that the rights of the shareholders of The Marion-Reserve Power Company shall be altered by amendment of the Agreement of Consolidation and Merger of The Marion-Reserve Power Company whereby certain voting rights and representations will be granted to the holders of the $5 Preferred Stock of The Marion-Reserve Power Company.

The joint application filed by the Marion-Reserve Power Company and Utility Service Company is in regard to a proposal to contribute 9,101 shares of $5 Preferred Stock of The Marion-Reserve Power Company by Utility Service Company to The Marion-Reserve Power Company for cancellation and to acquire these shares by The Marion-Reserve Power Company.

Since all of the above matters are a part of the general refinancing program of The Marion-Reserve Power Company, the hearings on all applications or declarations and amendments thereto have been set for the same day, February 13, 1940.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

[F. R. Doc. 40-481; Filed, January 31, 1940; 12:32 p. m.]